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THE NEW YORK

# Certified Public Accountant

September 1961 Volume XXXI No. 9

## CONTENTS

# Accounting News And Trends

BANKER-ACCOUNTANT SURVEY OF ACCOUNTANTS' REPORTS

A preliminary report of the activities of the CPA-Banker Research Institute of Texas appears in *The Texas CPA News Bulletin* (June 1961). This Institute is under the joint sponsorship of the Society and the Texas Chapter of Robert Morris Associates, with each group cooperating fully and exercising equal control.

To date, approximately 3,000 check lists have been prepared as a result of a random sample of accountants' reports as found in 70 banks in Texas. The information gathered did not include the names of the borrower or of the accountants preparing the reports. This was actually a fact-finding survey to determine how well accounting practices are serving the needs of bankers in this area. Special care was exercised in the selection of the reports to be included in the survey to prevent possible bias and it is believed that the reports gathered are representative of all those presently being prepared in Texas by other than company accountants.

One immediate bit of information which may be of interest is the proportion of reports among the 3,000 which were in violation of Rule 18 of the Rules of Professional Conduct—situations in which no clear-cut expression of an opinion or a disclaimer was made. On a state-wide basis it was found that approximately 9 percent of the reports, prepared by CPAs were in violation. A breakdown on a chapter basis, revealed that at least one reported that no reports of this type had been prepared by CPAs while another found that 33 percent had been prepared by CPAs.

This survey was restricted to a surface examination of the financial statements. No attempt was made to re-audit the audits or to ascertain the existence or non-existence of factual data to support them. For this reason it is believed that a lack of knowledge or insufficient fees could be a part of the cause of any discrepancies or inadequacies in the reports. The purpose of the Institute, in this project, was to determine the facts behind the existing reporting practices in order to point out where improvements are needed. The most frequent complaint among bankers was the inadequacy of the information furnished. Many times this information would be of the type that the accountant would have available but failed to include in the report.

Because no names were gathered there is no opportunity for any police action to come out of this survey. The Institute hopes that the interested parties so involved, regardless of reasons, will take steps to remedy any existing weaknesses that were found. Although the few that were the exception highlight this preliminary report, the Institute points out that, on the whole, the reports were of a good sound nature and were prepared in accordance with generally accepted reporting principles.

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**Accounting News and Trends is conducted by CHARLES L. SAVAGE, CPA. He is presently serving as a member of our Society's Committee on Accounting Procedure and is Program Director of the Brooklyn Chapter of the National Association of Accountants. Dr. Savage is professor of accounting and chairman of the Business Administration Division of St. Francis College. He is also professor of taxation at the New York Law School.**

THE PROFESSION'S MOST PRESSING PROBLEMS

The incoming president of the California Society of CPAs, Maurice J. Dahlem, answered some questions about his new job in that Society's *CPA Newsletter* (July, 1961). Two of these questions, with Mr. Dahlem's answers, are also of interest to New York CPAs.

*Q*. What do you consider the profession's most pressing problem? *A*. The problem is a gigantic one—educating the public as to our function and at the same time getting our own "house" in order by (1) resolving the basic issues of what are generally accepted accounting principles for reporting results of operations to stockholders and agreeing upon the auditor's responsibilities, and (2) then applying such standards objectively and with a high degree of competence.

*Q*. How do you view the future of the small CPA firm? *A*. I do not agree with the thought sometimes expressed that the small CPA firm is going to have difficulty keeping abreast. While it is possible that many CPA firms may tend to become specialists, I believe the future for small firms is bright. Their basic problem will be to recruit and retain adequate staff.

DEATHS PAY OFF

Death taxes paid to the federal government reached new highs in 1959, the most recent year for which official figures are available, according to a recent release by Commerce Clearing House. Amounts totalling $11,648 million were reported for gross estates of citizens and resident aliens on returns filed in 1959, which represented an increase of 13.2 percent over 1957. Taxable estates increased by 7.1 percent to $4,651

million. The number of estate tax returns filed showed an increase of almost 20 percent over the number filed in 1957.

Corporate stock predominated among estate assets, representing 43 percent of gross estates. Other estate assets and their percentages were: real estate, 21 percent; cash, 10 percent; bonds, 9 percent; annuities and life insurance, 6 percent; mortgages and notes, 4 percent; other property, 7 percent.

### THE "WHERE GOT, WHERE GONE" STATEMENT

In *The Accountants' Service Bulletin* (March 1961) published by the Burroughs Corporation, Roger Brumagim and Robert Rogers provide a simplified explanation of the "funds" statement. Any accountant who has prepared such a statement to explain to a client how he can have so little money in the bank when the income statement shows a substantial profit should also utilize the clear-cut explanations provided by the authors.

The Statement of Source and Application of Funds—the "Where Got, Where Gone" statement—is becoming increasingly popular and should be understood by the lawyers and business executives who use them. The authors point out that the word "funds" in this connection means working capital or excess of current assets over current liabilities, and not cash. The difference between funds provided and funds applied, of course, always equals the change in working capital. This fact, however, is sometimes obscured by including the change in working capital with either funds provided or funds applied so that the two sides of the statement are equal.

In presenting an explanation of the funds statement, the authors sug-

gest that if the client keeps in mind these basic concepts, understanding should be easy:

- "Funds" means working capital, not cash.
- Working capital is the excess of current assets over current liabilities.
- Funds Provided represents increases in Working Capital.
- Funds Applied represents decreases in working capital.
- Depreciation does not provide funds. However, since the net profit has been reduced by depreciation (a non-funds item), the depreciation must be added back to net profit in order to determine the amount of funds actually provided from operations.

THE END

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# Letters to the Editor

### STILL MORE ON AUDITING BANK DEPOSIT SLIPS

In your June 1961 issue, page 381, Mr. J. S. Seidman, CPA wrote a letter to the editor concerning auditing control of duplicate deposit slips in order to prevent fraud that depended on falsifying the source of deposits. Briefly stated there were five steps to this procedure:

1—Bookkeeper prepares deposit slip in duplicate.

2—Bookkeeper records details of the deposit on the duplicate.

3—Someone not in the bookkeeping department compares the checks and cash to be deposited with the detailed duplicate deposit slip.

4—The detailed duplicate deposit slip is retained by the auditor.

5—The bookkeeper makes the deposit, without asking the bank to stamp or confirm anything.

It is true that the above procedure will prevent the bookkeeper from lapping. However, by not giving the depositor proof that his deposit was made another danger exists. The bank teller is now in the position to commit fraud by the very same method of lapping.

In order to cover both possibilities of fraud by the bookkeeper and the teller, a bank deposit slip made in triplicate could solve the problem. Then the auditor could retain a detailed copy of the deposit slip and the bookkeeper would receive a confirmed copy of the deposit from the bank.

FREDERIC TISCH, CPA
New York, N. Y.

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# Book Reviews

ACCOUNTING SYSTEMS PROCEDURES AND METHODS

By Cecil Gillespie. PRENTICE-HALL, INC., Englewood Cliffs, N. J., 1951, 1961. Pages: iii + 641; $12.00.

Here is a practical how-to-do-it book for the accountant who wants to expand the scope of his services to clients. The practitioner's experience in accounting procedures and internal controls, together with his knowledge of the operations of his client, give him a background for developing skill in the increasingly important field of systems and procedures. A book such as this will show the accountant where and how to begin.

This book is written from the accountant's point of view. Its starting point is the general books of account, and it illustrates from this base the underlying plan of all the work of an office.

The first major section, on how to make the survey of office procedures, tells specifically how to go about the assignment, with illustrations of procedure surveys in specific companies. Since the key to successful systems work is an organized approach to fact gathering and analysis, methods of preparing notes, flow charts, operation lists, forms distribution charts and clerical workload schedules are illustrated in great detail.

A practical case study of accounting system development for a hypothetical distributing company shows how to design a set of general ledger accounts, a system of account coding, and the related financial statements. Basic plans for pen and ink journals are presented. Account forms are shown, for use with the accounting system developed. A chapter on systems and procedures reports shows a final report on the proposed accounting system for the hypothetical company. These charts will be valuable for the accountant called upon to design an accounting system for any client, large or small.

The next major section deals with the tools of the systems analyst's trade. Chapters cover the fundamentals of forms design, the development and uses of multiple-copy forms, and the equipment available for automatic writing and reproducing of forms. A chapter on account posting by bookkeeping machine will be useful to accountants called on to recommend machine systems. A chapter on cash sales procedures in retail stores gives much information on the use of autographic registers and cash registers, as well as on internal control and check. Sorting and filing equipment and devices are fully explained, as are the various types of visible records.

Considerable attention is paid to punched-card accounting principles, with full discussion of the major types of punched-card equipment. Punched card applications are illustrated in such areas as order processing and billing, perpetual inventories, accounts receivable, sales analysis, accounts payable, purchase distribution and payroll.

Electronic data processing is outlined, with a discussion of types of computers, major computer components, types of storage or memory, and binary systems for representing numbers and letters. A chapter on computer programming shows how computers are instructed to process in-

formation and how the computer works in processing information and making logical decisions. Specific examples show the programming of a hypothetical computer for typical payroll operations. An up-to-date chapter discusses the features and specifications of typical computers now on the market.

Last but not least are the sections on each of the basic systems in a business. These cover order processing and billing, sales distribution, accounts receivable and cash receipts, purchasing and receiving, accounts payable and cash disbursements, employment and timekeeping, payrolls, production controls, perpetual inventories, and cost systems. For each of these basic systems, the author discusses the function served by the procedure, the organization needed to operate it, which departments in the organization will benefit, the management information provided by the records, typical forms, typical clerical operations, methods applicable (from pen and ink through various degrees of mechanization), and the necessary procedures for accounting control and internal check.

While the accounting practitioner will find that there is no substitute for field experience in systems work, this book will give him a great deal of help in planning and organizing his approach, in learning the tools of the trade, and in approaching each of the major systems in the client's office with understanding.

RICHARD H. GOLDBERG, CPA
New York, N. Y.

RETAIL MERCHANDISE ACCOUNTING

By Hermon F. Bell, CPA and Louis C. Moscarello, CPA, THE RONALD PRESS, New York, N. Y., 1961. Pages: 476; $12.50.

This book presents in smooth, readable and logical manner the accounting procedures and problems of retail businesses, bringing up-to-date the two prior editions of this important work.

At the outset it discusses the conditions surrounding retail business, the various forms of operation, and the similarities and variations in their accounting problems and procedures.

Other of the 27 chapters deal with merchandise control, budgets, retail method of inventory control and the uses and control of the "Lifo" method for operational and tax purposes. Particularly useful is the material covering tax procedures and reporting.

Many illustrations are furnished of records and forms that have proven to be useful, and they should be helpful to one seeking to install or improve a retail business system. The determination of the figures used in the illustrated forms are followed through in line by line and figure by figure detail so that even one not conversant with accounting can understand them. Many practical and valuable suggestions are scattered throughout the book.

Charts and report form illustrations are well prepared, very helpful, and thoroughly and explicitly explained in simple terms. Formulae provided in connection with various points discussed are simple and easily understandable.

The authors are eminent in this field and their work may be considered authoritative and definitive. Students of retail accounting will find it very helpful, as will retail accounting and management personnel, as well as public practitioners.

SAMUEL LANG, CPA
New York, N. Y.

THE PRESIDENT'S PAGE

# The Importance of an Adequate Fee Structure

An adequate fee structure is vital to the well-being of both practitioners and the profession. The development of a successful accounting practice requires, apart from competence and personality factors, that the practitioner enjoy such annual income as will permit him to assume that position in his community—social, political and business—as will be beneficial to his personal and professional status as well as to his community and profession.

In addition, his income must be sufficient to provide suitable office space, well-paid accounting and other personnel, a good library, and all other necessary tangible and intangible accessories to facilitate good work and service. The practitioner must have spare time for himself, to research and think about client problems as well as his own. This means that he must use assistance to make possible the spare time needed for contemplative, development and recreational purposes.

All of the foregoing may be had only if the income from fees, net, not gross, permits it (unless one has independent income).

Adequate fees are also essential to the status of our profession, for several reasons. First, businessmen just do not view an accountant as a professional if he is paid at the rate of a good bookkeeper. Such situations react adversely on the profession. Moreover, poor work is often the result of inadequate fees. This, too, is bad for the profession. Poor quarters, poor typing, cheap-looking

reports, ill-dressed personnel, these and other aspects of poor income are not conducive of professional dignity and regard. Violations of our Society's code of ethics, another hazard to our profession, probably are largely attributable to conditions of financial pressure.

Much has been spoken and written about the subject of accounting fees and their development. This topic is discussed regularly at certain of our Society's technical committee meetings and at the informal meetings of members. The American Institute of CPAs has a course on fees that has proven to be highly practical and popular. In addition, the Institute's Committee on Management of an Accounting Practice has recently published, in its economic bulletin series, a very valuable pamphlet on the subject of fee determinations and policies. It is not necessary, therefore, to review here the factors underlying a successful fee structure; they are readily available to those who are really serious about it. It is important to urge that the securing of fair yet adequate fees get the same serious attention as clients' services.

If we are to compete with industry and other professions for the best young men to carry on our practices in the future, and to meet the responsibilities and potentialities of our continually expanding profession, we must have a fee structure that will enable us to attract, interest, and retain such young men.

Professional fees, in the last analysis, must be established independently by practitioners and not by their professional societies. Rate scales for personal services involving such diverse, intangible factors as experience, competence and status are impractical and undesirable. Moreover, anti-trust laws, though intended for business and industry primarily, might have to be taken into account in any group action.

EDWARD J. BUEHLER, CPA
*President*

# Accounting for Vacation Pay

*By* Richard S. Hickok, CPA

**The seemingly elementary subject of vacation pay is revealed as one having some serious accounting-legal problems. These problems are here analyzed and an approach to uniformity of accounting treatment is established.**

The accrual of vacation pay presents several intriguing problems for accountants, in both interim and annual financial statements. These problems are here discussed and recommendations for their solution are offered. It is hoped that the discussion will focus attention on the problem and that it will eventually lead to maximum uniformity in practical application.

Vacation costs are a substantial item of expense in most organizations, both small and large, relative to the number of employees and the total annual payroll. In the case of a company whose fiscal year ends during the second calendar quarter of the year and which grants vacations during the summer months, the amount involved may represent almost an entire year's vacation expense.

Though it is customary to recognize as liabilities on the balance sheet of a company all of its obligations which may be expressed in definite financial terms, which may be either due, accrued, or amounts payable at a future date or dates, it is not universally the practice, however, to record a provision for accrued vacation pay at a statement date.

The Internal Revenue Code of 1954, Section 462, permitted the deduction, for income tax purposes, of estimated expenses. Before this section of the Code was repealed, many tax accountants considered that it was desirable or necessary to record a reserve for all estimated expenses, including accrued vacation pay, to comply with the regulations. Accordingly, many companies established a reserve for accrued vacation pay. When this section of the Code was repealed, some companies reversed the provision in the subsequent accounting period; however, many companies continued to recognize the estimated provision for accrued vacation pay. Since that time there apparently has been little consideration given to this subject.

Some of the problems relating to accrued vacation pay are set forth below:

1. Should an accrual for vacation pay be recognized in the accounts in the absence of a contractual vacation plan?

2. Why should there be an accrual for vacation pay for employees covered by a contractual plan and no accrual for vacation pay appli-

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cable to employees not subject to a written agreement?

3. If an employee's vacation is attributable to past service, should not the expense be prorated over the period earned to properly match costs with revenues?

4. Should vacation expense be prorated during the year and recognized in interim statements, and how should the accrual be determined?

Consideration of this subject may logically be directed to the following areas:

- Vested vacation plans
- Non-vested vacation plans
- Accounting problems
- Interim financial statements
- Federal income tax considerations

## VESTED VACATION PLANS

It is fairly general practice for companies, both large and small, to establish a definite vacation policy for its employees. Under a publicized plan, all employees as of a certain date become eligible for a certain number of vacation days or weeks based upon their length of service as of a stated eligibility date. A vacation policy normally specifies the amount of vacation time, the period upon which it is based, the method of determining the amount and when the vacation may be taken. An example follows:

Eligibility date—May 1st

Length of service at May 1st and vacation allowable

Over ten years—3 weeks

One to ten years—2 weeks

Six months to one year—1½ weeks

One to six months—one vacation day for each month, but not in excess of five days

Vacation dates—as requested, with conflicts to be resolved on basis of seniority. All vacations to be completed prior to December 31st.

In a vacation plan where the employee has an earned right to a pro rata portion of the vacation in the event of termination prior to the end of the normal vacation year, the plan is considered to be a vested plan. Under such a plan an employee who was separated on January 31st would be entitled to receive nine-twelfths of the vacation he would normally receive on May 1st.

Union contracts for hourly paid employees frequently contain provisions with respect to the vacation rights of the employees covered by the contract. The auditor should, of course, review union contracts and the audit permanent file papers should include extracts of pertinent clauses of these contracts, including those provisions relating to vacation rights of the union members. These permanent files should include, as a minimum, the following type of information:

- Eligibility date
- Allowable vacation
- Procedure for determining vacation payments
- Procedure for controlling vacations taken in segments and cash payments (if allowed) in lieu of vacation
- Procedure for deferring vacations from one year to the next
- Employee's rights to vacation pay in the event of termination prior to the eligibility date
- Procedure used by the company in accounting for vacation pay in interim and year-end financial statements.

The auditor should similarly acquaint himself with the client's vacation policy for non-union hourly employees and for salaried employees. It may be that a company will have no formal vacation policy that gives vested rights to its employees but by

virtue of an ***established practice over a number of years*** a vested plan is, as a practical matter, in existence.

*Interim Accruals.* Companies that have a vested vacation plan should accrue a provision for vacation pay ratably over the period during which the employees earn the right to a vacation. Only in this manner can there be a proper matching of costs with revenues and a correct presentation of the financial position of the company during the period in which the vacation is earned.

### NON-VESTED VACATION PLANS

A non-vested vacation plan is one where there is no obligation on the part of the employer to disburse any pro rata vacation pay prior to the company's eligibility date. Under such a plan no vacation pay, as such, need necessarily be paid to employees terminated prior to the eligibility date or the completion of the vacation year.

In reviewing a company's vacation policy, the auditor should be alert to the actual practice in effect. It may be the intent of management that there should be no vested vacation plan; however, in practice, terminated employees may actually be paid pro rata vacation as a part of severance pay.

Similarly, it may be that one type of employee (perhaps union) may be a participant in a vested vacation plan while other employees (non-union or office workers) may be in a non-vested vacation plan.

### ACCOUNTING PROBLEMS

Prior to the second World War, the question of vacation pay was not particularly significant and it was a customary practice to charge the expense to the period in which the vacation was taken by the employee. As vacations have become standard policy for most companies and a matter covered by collective bargaining agreements in many cases, the question as to whether or not a liability exists and should be recorded on the books has become more important.

Many strong arguments can be brought to bear upon the question of whether or not a company should recognize a liability for accrued vacation pay at a statement date prior to the eligibility date previously discussed. These arguments revolve around the following major points:

Financial statements are normally prepared on a "going concern" basis.

The income statement should properly match costs and revenues.

What is a liability?

Those that argue that the liability for accrued vacation should be recognized, regardless of whether there is a vesting or non-vesting plan, will support their position by stating that the statements are prepared on a going concern basis, and that in order to properly match costs with revenues, the estimated liability at statement date for the portion of the vacation deemed to have been earned during the period should be recognized. A further argument to support the contention is conservatism in the financial statements.

The opponents of recognizing a liability for accrued vacation will argue that, under a non-vesting plan, no liability exists until the eligibility date. Furthermore, they may logically argue that unless the company has experienced a substantial increase in number of employees, each fiscal year will include a year's vacation payroll expense on a cash basis and, as a result, each year's revenues bear a reasonable charge for vacation expense. This latter point, however, considers only the effect on the income statement and

does not give any consideration to the effect on the balance sheet.

A liability is defined by Kohler (A Dictionary for Accountants) as follows:

> "An amount owing by one person (a debtor) to another (a creditor) payable in money or in goods or services; the consequence of an asset received or loss incurred; particularly any debt (a) due or past due (current liability) (b) due at a specified time in the future (e.g., funded debt, accrued liability), or (c) due only on failure to perform a future act (deferred income, contingent liability)."

There is a growing philosophy that the vacation is a "right" that the employee has earned for services performed in the past, and that it is not just a period of rest to prepare for future services. On this basis it appears that there is an accrued liability due at a specified time in the future (i.e., the eligibility date) for past services performed by the employee. Despite this contention, no liability on a liquidation basis exists at a statement date earlier than the eligibility date for a company with a non-vesting plan. A legal opinion may be necessary to determine whether or not an actual liability exists, in the absence of a vesting plan, but where past practice may have, in effect, created the equivalent of a vested right.

As accountants, however, we are not solely concerned as to whether or not a legal liability exists at statement date on a liquidation basis. The statements are normally prepared on a "going concern" basis and that principle is applied to all items in the accounts. It should similarly be applied to accrued vacation pay to properly match costs and revenues and to properly reflect the accrued expense in the financial statements.

## INTERIM FINANCIAL STATEMENTS

The significance of vacation expense on costs has developed the need for a logical basis of applying this cost to earnings for interim financial statements. As a result, several methods have been devised to charge costs monthly and credit a liability or provision account. As vacations are taken, the liability account is charged, and the liability account (which may be a deferred account at some periods of the year) and expense account are adjusted when the actual expense is known. The most common method of recording this expense is to accrue equal monthly amounts based upon an annual estimate of the total vacation expense.

Another method of recording this expense is to use an estimated percentage applied to the payroll of each period.

The practice of accruing vacation pay for interim statements, as briefly described, generally applies only to the vacation expense for hourly paid employees. Most companies consider the vacation pay of salaried personnel to be a cost, if any, of the period when the vacation occurs, for many reasons. One reason is that often no out-of-pocket cost is incurred. Sometimes employees hold down two jobs, as an aid to vacationing fellow-employees, or, the work just waits for an employee to return.

The recognition of vacation expense in the accounts eliminates distortion on interim earnings, but let us consider whether the liability is properly recognized in the accounts at every appropriate date.

Obviously, if the eligibility date is May 1st, a definite liability to the employees exists at that date under both a vesting and non-vesting plan payable during the vacation period. However, if the total annual vacation cost

for hourly employees is recorded by equal monthly accruals from January to December, the liability at May 1st will only represent one-third of the amount actually owing at that date. As to salaried employees, the practical effect should be essentially the same.

It should be recognized at this point that accounting for interim reporting is often a little different from annual reporting. The accounting for annual reporting purposes places greater emphasis on the balance sheet than is customary in interim accounting practices. With interim financial reporting, the principal aim in most cases is to report monthly operating results to assist management. However, the interim balance sheet is frequently of importance in maintaining credit lines.

It should be remembered that interim statements, including the balance sheet, are often distributed to interested parties other than management, such as stockholders, banks and other creditors, etc. CPAs are often requested to express an opinion with respect to interim statements. If they omit a significant liability for vacation pay, an opinion is not in order.

### FEDERAL INCOME TAX CONSIDERATIONS

Revenue Ruling 58-18 holds that where the liability for accrued vacation pay is based upon a vested plan, a deduction for the amount of the liability is allowable even if the plan is not based upon a formal contract (as in the case of a union agreement) but only on a statement of company policy. It is necessary, of course, to notify the employees as to the company policy.

In the fiscal year in which there is a change in the vacation plan from non-vesting to vesting, a double deduction results. As this change is one in the method of operation rather than of accounting method, permission is not required to adopt the accrual method of deducting vacation pay.

Where a change of this type is adopted, the financial statements for the subject year will include a charge for both the vacations paid during the period and the vacation pay earned during the year but not yet payable. In these instances, the duplicate charge, net of related Federal income taxes, should be set forth as a special charge below net earnings for the year.

### SUMMARY

At an annual statement date, such as December 31st, prior to the eligibility date of the vacation plan, most accountants are in agreement that the liability for accrued vacation pay should be recorded for those employees covered by a vested vacation plan. This is true whether the vested plan is the result of a formal contract or merely an informal company policy.

The amount of the accrued liability at the annual statement date should represent the ratio of the number of months since the last eligibility date to twelve times the estimated vacation expense for the year. Therefore, for a company with a May 1st eligibility date and a December 31st statement date, eight-twelfths of the estimated vacation expense would be accrued. It should not be expected that the amount accrued at December 31st will be exact when determined in this manner; however, the result should be reasonably accurate.

In those companies that have, in fact, a non-vesting vacation plan, the obligation of the company does not exist until the eligibility date. Therefore, at a statement date prior to the eligibility date, it is not general practice to record any liability for accrued vacation pay in the absence of either a formal or informal vested plan.

Despite this general practice, for those companies that have no vesting features in their vacation plans, but who by virtue of general practice over many years commit themselves to grant vacations in the future, it is a preferable accounting policy to record vacation as earned by the employees (even though the rights of the employees do not accrue in the same manner) to achieve a proper matching of costs and revenues. From a practical point of view, unless there has been a marked increase or decrease in the number of employees from one accounting period to the next, the failure to record this expense and accrue the vacation cost would have little effect on the income statement for the period. It must be recognized, however, that the balance sheet in these instances does not give any consideration to this accrued liability at the statement date.

Although it is not uniformly general practice to record the accrued liability for vacation pay in the absence of a vested plan, it is better accounting to provide for vacations as they are earned by employees. The result is a more accurate matching of costs with revenues. In addition, when vacation allowances are accrued ratably as they are earned, the total liability will be recorded at the eligibility date and as a consequence the expense and the liability will be correctly reflected in the interim financial statements.

It is recognized that there are many problems and that a considerable amount of opposition will be encountered before there is general acceptance of uniform accounting for vacation allowances. In the interim CPAs should attempt to have new clients, especially newly formed companies, provide for vacation allowances on a sound accounting basis and to strive to overcome reluctance on the part of existing clients to accept a change in accounting treatment for vacation pay.

For the present, in the absence of a vested vacation plan, the auditor should review annually the client's vacation policy and the method employed to account for vacation costs. The auditor should ascertain that there is no significant mismatching of costs and revenues due to the accounting procedures for vacation pay employed by a company with a non-vesting plan.

The auditor should not assume that a company with a non-vesting vacation plan will not change to a vesting plan at some future date. Changes in union contracts, company policy, and perhaps even social legislation in the future could change a company's plan from non-vesting to vesting with a resultant change in the accounting for vacation costs.

It should be borne in mind that there can be more than one type of vacation plan within a company, some of which give vested rights to employees and some of which do not have vesting privileges, and with different accounting treatment based upon the type of plan.

In those instances where the financial statements are being prepared at a date subsequent to the eligibility date, the auditor must ascertain that the liability for vacation cost is properly reflected. The proper recognition of this liability is of particular importance where an examination is being made for the purposes of a merger or acquisition.

The problem of the liability for accrued vacation pay is one which the auditor cannot avoid, and must resolve, on almost every examination. It is hoped that this brief discussion will highlight the major factors relating to the accounting for vacation pay that the auditor should consider.

THE END

# A Public Interest Code for American Business

*By* Hon. Jacob K. Javits

**U. S. Senator Jacob K. Javits (R-N. Y.) was the featured speaker at our Society's annual dinner held on May 8, 1961. His paper received such acclaim as to warrant its reproduction for the benefit of members who were not able to attend.**

**In his remarks, aside from this paper, the Senator made a strong point about the important role of accountants, as a major advisory force in the field of business, in helping to bring about the necessary improvements in our economy and in its structure.**

I should like to talk to you today about the state of the U.S. economy and the role of U.S. business—which I define to include labor, management, farmers and voluntary organizations—in helping to insure our security and to spur the economic progress of the American people and the peoples of the free world.

We are meeting a great challenge in foreign affairs and our attention has been correctly focused on the Congo, Laos and Cuba. But we are also meeting a great challenge in our domestic economy and in a mounting Communist economic offensive.

At home we have been in a real recession—a recession characterized by high and hard core unemployment and an imbalanced international balance-of-payments. The imbalance in international payments was substantially improved during the first quarter in 1961, but remains a danger. High unemployment remains a sore spot; and hard-core unemployment remains a stubborn aspect of our economy that we have so far failed to solve.

The basic problem of our country is to effect an adequate mobilization of our resources, public and private, to support our role for effective peace leadership in the free world; and for the development, proportioned to that leadership, of our American society.

The theory that our economy will automatically adjust is not adequate to the problems and responsibilities we have today, nor to the acceleration of timing brought on by the Communist economic offensive. We need government-business coordination to make our economy operate to produce enough and in the right lines to meet our economic responsibilities in the public interest. I am convinced that the techniques to achieve this purpose are available without such Federal Government direction and control as will seriously endanger individual freedom.

Our strength is production based on the dignity of the individual and on the good faith of credit. We have overwhelming economic power to make this principle good in terms of the well being of peoples in the neutralist areas and in the areas, newly-self-governing, which will determine which way the world goes. Our Government's policy must be the recognition of this essential base for the free world's success, and the determination to marshal our resources, public and private, with the boldness, vision, and discipline required for their effective utilization for this grand design—and for their coordination with the similar resources of the other leading industrial nations for the same purpose—as, for example, in the newly organizing 20-nation OECD (Organization for Economic Cooperation and Development).

One of the chief concepts of modern, progressive political thinking is that we can achieve our maximum economic potential by means of our private economic system operating in the public interest.

In accordance with this concept, I would like to offer to you, as a suggestion of how business can operate in the public interest, a Public Interest Code for American Business. I know it will take much refining but here is at least a 10-point start on a vital issue:

1. Dealing with corporations, employees, stockholders and consumers in the ethical spirit of trusteeship; and acting as good citizens in dealing with government officials.

2. Making every effort to eliminate featherbedding, in management as well as in labor, as being in the national interest, which demands maximum productivity.

3. Encouraging stockholder democracy through maximum voting, full disclosure and other participation.

4. Extending the benefit of restricted stock options or other means of profit-sharing and wage security to workers generally.

5. Moving vigorously to eliminate discrimination or segregation in employment on grounds of race, religion, sex or age.

6. Expanding research, corporate participation in education and activities in natural resources conservation.

7. Determining the level of prices and wages in terms of the best interests of U.S. economic policy generally in addition to private considerations.

8. Participating in adjustment assistance to competitors and others in its community or trade, incident to technological obsolescence, concentrated imports or automation.

9. Observing the anti-trust laws in letter and spirit and participating in developing trade association cooperation in research, standardization of product, quality and other permissible affirmative activities.

10. Supporting U.S. foreign policy through foreign private investment, expansion of export markets and making available technical assistance facilities for foreign use.

We need to move in a number of ways as a nation to fully utilize our resources to meet our great challenges at home and abroad and to attain a new plateau of economic effectiveness and well-being.

• A U.S. productivity drive is essential.

• Enlistment of the cooperation of labor and management is essential for

the fullest utilization of our economic potential.

• A national policy of affording equal opportunity in employment, education, housing and the exercise of their civil rights to all elements of our population, regardless of color or religion, is basic, also, to the entire effort toward productivity expansion.

• A U.S. peace leadership requires a great expansion of our foreign trade, which represents our largest economic commitment to world affairs except for defense expenditures.

• The international economic policy of the United States requires new media for coordinating the economic efforts of the free world.

• U.S. policy must lead, on even a broader scale, toward the establishment of international banking and credit facilities which will provide for the increase of liquidity, which is the essential basis for the rapid expansion of international trade.

• There must be a constant effort to draw upon the economic strength, technological skills, and managerial know-how of the private sector of our economy in carrying out our international economic policies.

There, then, are some of the ideas, some of the opportunities we can take to spur the economic progress of the American people and the world, not now being brought forward and developed by the Administration. They are more than just the immediate measures needed to deal with the recession. They represent the real essence of the economic struggle. And they would demonstrate that we understand the basis for free world stability and that we are determined with all our resources to join with the rest of the free world in building that basis on a solid foundation. THE END

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## The Super-Salesman

What is the "mystique" of super-salesmanship? What enables some persons, with or without technical competence, to sell, while others cannot seem to? Where is the source of "creative" salesmanship? Why is it said by many that salesmen are "born, not made"?

My answers to these questions are not popular ones, and they will not endear me to some audiences. But I feel they are much more realistic than the glib, glad-handing treatments that so often have characterized "trait and work habit" discussions; they get us much closer to *people,* as contrasted with abstractions or ideal types. We all need a stiff corrective, I am afraid.

It is my conviction that the possessor of an *effective* sales personality is *a habitual "wooer," an individual who has a compulsive need to win and hold the affection of others.* He is not born with this need; it is the product of his early environment. But it develops so early in life that for all practical purposes it might as well be inborn.

Robert N. McMurry, "The Mystique of Super-Salesmanship,"
Harvard Business Review, March-April 1961

# The 20% Salary Reduction Plan On Annuities for Non-Profit Organization Employees

*By* SAMUEL L. STEINWURTZEL, CPA

IRC Section 403(b) and private Service rulings pertaining thereto, provide a tax-advantageous opportunity for employees of non-profit organizations that are tax exempt under Section 501(c)(3), to build up larger annuities for their retirement benefit. Large numbers of employees and employers are affected and as knowledge of this plan, referred to as the 'Salary Reduction Plan,' (hereinafter sometimes referred to as SRP) becomes more widespread, accountants can expect to be consulted increasingly about its provisions, advantages and disadvantages, and the conditions that must be observed.

The Salary *Reduction* Plan must be distinguished from the Salary *Withholding* Contributory Plan which is a conventional pension plan entailing contributions by employer and employee. In the latter plan the employee's withheld contribution constitutes a part of compensation that has been taxed, while SRP enables the employee to effect a contribution to his annuity fund with dollars representing compensation that is tax deferred. SRP may be utilized to replace salary withholding or for that matter in conjunction with any other retirement annuity plan, contributory or non-contributory, subject to certain limitations.

The plan is rather complicated and the history of its use reveals a good deal of controversy and confusion. Section 403(b) of the Internal Revenue Code as amended in 1958, and official statements, have done much to clarify previously unanswered questions but there still remain some uncharted areas. This article describes the plan, its basis in the law and the support that it derives from private rulings and Senate Committee reports. Also, reference is made to attendant problems such as personnel policies, fringe benefits, accounting procedures and other operating factors.

**SAMUEL L. STEINWURTZEL, CPA, is a member of our Society's Committee on Accounting for Non-Profit Organizations. This article has been adapted by the author from a paper presented by him at a recent technical meeting of the committee. Mr. Steinwurtzel is also the Comptroller of the State Charities Aid Association, New York City.**

### THE PLAN

SRP is a tax deferral plan whereby an employee of a 501(c)(3) employer may take a reduction in salary or forego an impending increment, within the limits of the 20% Exclusion Rule, in consideration for which the employer contributes the amount of the salary reduction or the increment to the employee's annuity fund. The amount of the contribution is not taxable to the employee currently but at the time benefits are received.

Thus, an employee earning $15,000 who has had his employer withhold

$1,000 a year from his salary towards an annuity under a conventional Salary *Withholding* Plan pays income tax on $15,000. Assuming he is in the 30% bracket, his tax on the $1,000 contribution is $300. The contribution therefore costs him $1,300 in actual dollars. If he converts his contribution to the Salary *Reduction* Plan his salary is reduced to $14,000. His employer then contributes $1,000 to his annuity account but he is taxed on only $14,000. As a result of the change from the withholding method to salary reduction, the employee increases his take home pay by $300. If, moreover, he invests the $300 in his annuity contract, via salary reduction, he will further enhance his annuity without any current out of pocket cost. In addition, the $300 sum produces earnings as the annuity accumulation builds up over the years, which he otherwise would not have.

It is conceivable that on retirement an employee may not have taxable income. For example, an employee could have as much as $6,000 of income at retirement without having any tax liability, if the income consists of social security benefits of $2,300 for the husband and wife and $3,700 in annuity payments. The social security benefit is not taxable. The annuity payments are taxable only on the portion that had not been taxed previously. Such untaxed portion would represent either, or both, SRP contributions and the employer's own contributions. Assume in this situation that $2,700 of the annuity is subject to tax—$2,400 would be deductible as the double exemption of the husband and wife at 65, and, in most situations, there would be at least $300 of itemized deductions available or as a minimum $270 as the 10% standard deduction. Therefore the result is no tax or virtually no tax. We could speculate further in this direction. However, other situations could readily result in tax increases instead of reductions.

### THE 501(c)(3) EMPLOYER

The Salary Reduction Plan is exclusively applicable to an employer that is a non-profit organization, tax exempt as defined in 501(c)(3) of the Internal Revenue Code. The Code describes the subject employers as follows:

'Corporations, and any community chest, fund or foundation organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.'

### SECTION 403(b)

Section 403(b), (created by the Technical Amendments Act of 1958) does not authorize the Salary Reduction Plan, per se. All the code states is that a 501(c)(3) employer's contribution to his employee's annuity within the limits of the 20% Exclusion Rule is tax deferred. It is the recent private rulings of the Internal Revenue Service that specifically approve the Salary Reduction Plan. In addition, statements of the Senate Finance Committee made during hearings on legislation which subsequently became Section 403(b) of the Code, support the Salary Reduction Plan.

### ANNUITY RESTRICTIONS

The Internal Revenue Service has not defined 'annuity' in complete,

clear-cut language but it has issued Revenue Ruling 55-639 which offers some guidance. The ruling states that an annuity contract provides primarily for periodic installment payments to the annuitant named in the contract and that the death benefits may not at any time exceed the larger of the reserve or the total premiums paid for the annuity benefits. Obviously this excludes life insurance.

The ruling is couched in general terms and we need to look to the code, Section 403(b)(1), to more carefully delineate the type of annuity that is eligible for special tax treatment. The code establishes three specific criteria in its Subsections (A) (B) and (C) which are the only additional requirements that must be met.

(A) the annuity must be purchased for an employee by a 501(c)(3) employer.

(B) the annuity contract is *not* part of a qualified plan.

(C) the employee's rights are nonforfeitable.

As to qualified plans—any organization, whether it is profit making or a 501(c)(3) type may adopt a qualified plan. Some 501(c)(3) organizations provide qualified plans for their employees, but this does not preclude them from offering non-qualified annuities in addition and in this way utilize the Salary Reduction Plan for the supplementary coverage.

### THE 20% EXCLUSION RULE

This is a formula in Section 403(b). It establishes the limit of the annual tax deferral of the employer's contribution to his employee's annuity. The exclusion allowance equals 20% of the current salary of an employee, times his years of service, less prior contributions made by the employer which have been excluded from the employee's income tax. The maximum of 20% was fixed in an effort to overcome prior abuses of the tax deferral privilege.

*Calculation Of The Exclusion Allowance.* The employee's Exclusion Allowance is of utmost importance in determining the permissible amount of tax deferral. The formula for its calculation is embodied in the language of the Code, Section 403(b), in sub-section 2, which states (italics added):

> "For purposes of this sub-section, the *Exclusion Allowance* for any employee for the taxable year is an amount equal the excess, if any, of—
>
> (A) the amount determined by multiplying (i) 20% of his *includible compensation,* by (ii) the number of *years of service,* over
>
> (B) the aggregate of the amounts contributed by the employer for annuity contracts and excludable from the gross income of the employee for any prior taxable year."

The meaning of the terms *includible compensation* and *years of service* must be carefully determined. Briefly, includible compensation is the amount of salary received from the employer computing the exclusion allowance, reportable for income tax purposes. Years of service simply means years of employment. Treasury Decision 6335 defines this term in detail, and covers full and part-time employment.

Three cases are here submitted to illustrate the calculation of the exclusion allowance. Case A is an example, in the simplest form, or the calculation of an exclusion allowance for an annuity fully financed by an employer, Cases B and C illustrate the calculations for a Salary Reduction Plan exclusion—Case B concerning a full-time employee and Case C a part-time employee. It will be observed in these two cases that the exclusion allowance is

a factor in its own determination, therefore requiring an algebraic formula computation.

### ILLUSTRATIONS OF EXCLUSION ALLOWANCE DETERMINATIONS

*Case A—Employer Financed Method —Full Time Employee*

Contract salary—$15,000 per annum

Years of service—9

Total exclusion for 9 prior years—$18,000

Maximum exclusion for tenth year:

| | |
|---|---|
| 1. 20% of $15,000 x 10 (years) | =$30,000 |
| 2. Deduct total prior exclusions | 18,000 |
| Maximum exclusion —tenth year | $12,000 |

*Case B—Salary Reduction Plan*

Facts—same as in Case A

Maximum exclusion (E) for tenth year:

E=20% of $15,000 minus E, x 10 (years), minus $18,000

E=2 ($15,000–E)–$18,000

E=$30,000–2E–$18,000

3E=$12,000

E=$4,000

*Case C—Salary Reduction Plan—Part-Time Employee*

Part-time arrangement—25% of time

Contract salary—$5,000 per annum

Years of service—9

Total exclusion for 9 prior years—$5,000

Maximum exclusion (E) for tenth year:

E=20% of total salary for 4 most recent years, including current year, minus E
times, years of service including tenth year multiplied by part time percentage
minus, total exclusions in 9 years

E=20% of ($20,000–E) x 2½ (years)–$5,000

E=50% of ($20,000–E)–$5,000

E=$10,000–½E–$5,000

1½E=$5,000

E=$3,333

### PRIOR LEGISLATION AND RULINGS

Let us look briefly at the background of legislation that led to Section 403 (b) and its 20% Exclusion Rule so as to place the Salary Reduction Plan in its proper perspective. The 1939 Code, and for that matter the original 1954 Code, placed no limitation on the amount a 501(c)(3) employer could contribute to an employee's annuity without such contribution being taxed to the employee currently. No mention was made of Salary Reduction Plan. Most non-profit organizations established reasonable limitations on their contributions but to some few the permissiveness of the code meant 'the sky's the limit.' These employers paid selected employees, largely part-time workers, most or all of their compensation in the form of tax deferred annuities.

Such abuses led the Internal Revenue Service to apply some limitations in its Revenue Ruling 54-267 and later in 1956 in Regulation 1.403(a)-1(a)(3), but these were quite drastic. The ruling and the regulations in part held that tax deferment would not be recognized on an employee's income tax return if the contribution to his annuity by his employer consisted of reductions in salary or amounts in lieu of a salary increment. This of course ruled out the Salary Reduction Plan entirely.

Not long afterward, in the years 1956, 1957 and 1958, House and Senate Committees undertook a review of annuity activities of 501(c)(3) organizations, as part of their extensive effort to correct inequities and unintended income taxes bene-

fits. The legislators concerned about the practices of some 501(c)(3) organizations devised the 20% Exclusion Rule and other provisions of Section 403(b) as a means of curbing the excessive utilization of tax deferred annuities. The new code actually bears little resemblance to the Commissioner's Ruling and Regulations. It does not prohibit the Salary Reduction Plan nor does it mention it.

In reporting the legislation, the Senate Finance Committee stated 'Your committee intends the objective 20% Rule as a complete substitute for the rules in the Regulations.' Note the word 'objective.' This is the key to the interpretation. The legislators felt they had found a reasonable, objective method of limiting tax deferment that was fair and equitable.

Other noteworthy comments in the published accounts of the Senate Committee hearings provide valuable guidance in the use of the Salary Reduction Plan and they are summarized below:

(1) The Committee takes exception to the use of the Salary Reduction Plan on salary that had been earned prior to the election of Salary Reduction Plan, i.e., salary constructively received and then converted into an annuity. (In other words, stated positively, the Committee approves the Salary Reduction Plan if used on salary earned prospectively.)

(2) As regards the exclusion allowance formula, includible salary consists of compensation which the employee receives from the employer who is computing the exclusion allowance, and no other employer.

(3) Again for purposes of the formula, prior contributions consist of amounts contributed by an employer to all plans whether they be qualified or non-qualified.

(4) A forfeitable annuity becomes subject to the 20% Exclusion Rule at the time of vesting.

(5) A 501(c)(3) employer may provide qualified and non-qualified plans for its employees. The qualified plan is subject to the provisions of Section 403(a) of the Code and the non-qualified, of course, to Section 403(b).

As things stand, the Senate Committe has stated its position and Section 403(b) is in the code. Nonetheless, the Internal Revenue Service has not yet officially revoked the 1956 Regulations but its recent private rulings accept the Senate Committee's point of view and conform to the code. The rulings state unequivocally that a 501(c)(3) organization may use the Salary Reduction Plan excepting on salaries earned prior to the election of the plan. Another private ruling indicates that even if the salary is voted by a Board of Directors the Salary Reduction Plan may be used.

### THE IMPORTANCE OF THE SALARY REDUCTION PLAN ON PERSONNEL RELATIONSHIPS

Of particular importance is the effect of SRP on personnel relationships in an organization. Here is an area where the certified public accountant can serve as a management advisor. By presenting the pros and cons he can assist an organization in arriving at a decision.

Actually, an organization has five choices as regards SRP, namely:

- It can ignore it entirely.
- It can defer a decision pending issuance of regulations by the Internal Revenue Service.
- It can go the whole way and offer SRP to the entire extent of each employee's exclusion allowance.

- It can offer SRP on a limited basis using an appropriate percentage of exclusion allowance applicable to all employees to obviate calculations of individual allowances.
- If it has a salary withholding-contributory plan, it can offer SRP as a substitute for salary withholding.

However, before an organization can determine its policy, it needs to examine and weigh the favorable and adverse factors. These are the common favorable factors:

- SRP offers an organization a valuable tool for improving its position in the employment market, and to some extent it provides a measure equivalent to the deferred compensation plans of commercial organizations in the competition for personnel.
- The employee, benefiting from the program, attains a greater sense of security with the result that the organization has a more satisfied, stable staff member.
- The use of the plan is based on sound legal grounds. The code together with the statements of the Senate Committee and recent rulings give such assurance.
- Employees may be able not only to defer income taxes but in some instances, depending on the financial circumstances and income tax rates, may also reduce and possibly eliminate income taxes. The organization can ill afford to deny this opportunity to an employee if he requests it.
- With the expansion of the aged population, this group of subject employees may be able to exercise increasing political influence to achieve a reduction of income taxes for retired persons, so that tax deferrals can result in greater savings than currently anticipated.

While the arguments on the favorable side seem most convincing in favor of SRP, many organizations have their doubts, pointing out these adverse factors:

- The use of SRP requires complex administrative procedures.
- The Internal Revenue Service may adopt restrictive regulations and also the code can be changed.
- Generally, employees in higher salary ranges are more likely to take advantage of the plan since they can afford to place more funds in their annuities. The larger number of employees, in the lower salary brackets, however may not use it.
- Income tax rates may increase in the future, or an employee may possibly have more taxable income after retirement, thus causing SRP to boomerang.
- The employee's social security benefits might be affected if his salary is reduced below the social security salary maximum of $4,800 (in 1961).

### FRINGE BENEFITS

The use of SRP raises a number of questions as regards the computation of fringe benefits, such as social security, disability insurance, sick leave and group life insurance. SRP involves two different salary figures (1) the *contract* (base) *salary,* which is the agreed rate of compensation between employer and employee and (2) the *reduced salary,* which is the taxable salary. The problem is created by the question as to which salary counts for fringe benefits and payroll tax purposes.

Fringe benefits are of two classes. The 'legal' type e.g., social security taxes and in New York, state income taxes, are applied to the reduced salary. Benefits of a discretionary nature, where the organization has a choice, e.g., sick leave, group life insurance, disability insurance, are applied by most organizations against the contract (base) salary of employees.

### PROCEDURES FOR ADOPTING THE SALARY REDUCTION PLAN

Organizations adopting SRP need to make certain that adequate measures are taken to meet all requirements. The responsibilities must be made perfectly clear. The employer, of course, makes the arrangements. He determines the exclusion allowance and the extent to which it will be used. These calculations must be accurate and in compliance with the legal requirements, otherwise financial liabilities can be incurred.

The employee must be fully informed as to the advantages and disadvantages of SRP, since he is a party to the arrangement. This should be done in a memorandum by management. Then, too, for the protection of the organization and the employee, a written agreement should be devised that sets forth all the essentials. (Specimen included at end of article.)

With respect to bookkeeping, certain measures are also needed. An account should be set up to record the employer's contributions to annuities representing salary reductions. The account may be called 'Contributions to Annuities—Consisting of Salary Reductions.'

The payroll records should show the reduced salary amounts, while the personnel records of the staff member should indicate the contract salary. The employee's earnings card, of course, should tie in with the payroll and show all the details related to the taxable salary. It might be desirable to set up a separate earnings card for the salary reductions that were converted into employer's annuity contributions. The two cards together will then produce the contract salary.

In the statement of operations the two accounts, 'reduced salary' and 'contribution to annuities' should be combined and the total shown as salaries. In terms of the organization's expenses, the contributions of salary reductions are no different than salary except that instead of being paid to employees directly, they are paid to the employees' annuity contract fund.

### CONCLUSION

SRP offers certified public accountants an excellent opportunity to provide an important service to 501(c)(3) organizations. Here, the certified public accountant can help bridge the gap between available knowledge and its possible use. The case for the plan is clear and 501(c)(3) organizations are, at the least, entitled to have a chance to consider it. The plan is a reasonable device in the light of our present social outlook, in that strong emphasis is being placed these days on the financing of retirement years. It is also reasonable in comparison with the opportunities available to employees of commercial organizations who can defer as much as 25% of compensation into pension, annuity and profit sharing plans and in addition, they also use such devices as the restricted stock option.

Obviously the certified public accountant should not decide whether an organization should adopt SRP but without a doubt he should be in a position to bring all the facts to the attention of management and in addition keep abreast of new developments as they arise. In the final analysis it

is up to management to make the decision as to the adoption of SRP voluntarily or in response to the requests of employees.

BLANK HEALTH ASSOCIATION

AUTHORIZATION FOR SALARY REDUCTION AND CONVERSION OF SUCH REDUCTION TO AN EMPLOYER'S ANNUITY CONTRIBUTION UNDER THE 20% EXCLUSION RULE, 1958 TECHNICAL AMENDMENTS ACT OF THE INTERNAL REVENUE CODE.

Effective on                          please reduce my monthly salary by the amount of $                    and at the same time increase the contribution of Blank Health Association to my retirement annuity by a corresponding amount. This election is irrevocable until                          . Any change thereafter must be made by completion of a new authorization form prior to the effective date of the change and will be applicable only to salary on or after the effective date of the change.

It is noted that the Internal Revenue Service has not issued regulations prescribing procedures for the conversion of salaries to employer annuity contributions as agreed herein. Also, information is not available from the New York State Tax Commission on this subject. In the circumstances, Blank Health Association has taken appropriate measures to determine the amounts allowable but should a tax deficiency in either federal or state taxes develop as a result of such determinations, it is understood that the staff member will assume responsibility for such deficiency.

Witness                                                                    Date

Signature of Staff Member

Witness                                                                    Date

Accepted—Executive Director

BLANK HEALTH ASSOCIATION

# The Management Letter — An Annual Report Supplement

*By* WILLIARD E. STONE, CPA

**An auditor's observations during an engagement can yield ideas on operations—system, organization, procedures and policies—that may be meaningful both to his firm and to his client. The communication of these ideas should be formalized in a management letter. They should not be expressed haphazardly nor solely in oral form. The author makes a good case for following up an annual report with a supplementary management letter.**

The certified public accountant has won the respect and confidence of both the public and management. Stockholders, creditors, governmental agencies and other parties interested in the financial affairs of corporations as "outsiders" have come to accept the CPA as a highly competent, impartial third party whose reports are objective and can be relied upon. Management has learned to look upon the auditor as a dependable advisor whose professional training and broad business experience brings an objective and discerning viewpoint to a wide variety of business problems. This is the dynamic phase of the auditor's work and it is becoming the phase that management looks upon as the most valuable. With the growing recognition of the auditor's function in the field of management services, it becomes important to examine carefully the media by which the CPA formalizes this service. Most large accounting firms are now using a "management letter" for this purpose to supplement their annual reports. It is distinguishable from a letter or report on a special services engagement.

The management letter is a written communication from the Certified Public Accounting firm to its client pertaining to various matters, disclosed by the audit, relative to the company's operations. It is an informal report, and contains comments and suggestions which are of importance administratively but which are not suitable for inclusion in the auditor's report which, in many cases, receives public distribution.

Letters of this nature have been used, upon occasion, by almost every practitioner. The fact that many large CPA firms now make a regular practice of sending such a letter after the termination of an engagement justifies placing a more formal emphasis on the term "management letter."

**WILLIARD E. STONE, CPA, is Professor of Accounting, and Department Head, at the University of Florida.**

## VALUE OF LETTER TO ACCOUNTANTS

Reporting matters concerning the internal operations of a business in a separate letter places greater emphasis

on audit findings. John W. LaFrance has pointed out that: ". . . too frequently managerial information is sandwiched in the audit report. This information should be separated from the regular report in such a manner as to be easily accessible to management."[1]

The management letter also is an excellent device for directing the attention of the client to additional services available through the management services function of the accounting firm. Weaknesses in the client's management organizational structure, the accounting system, production scheduling, the cost system and many other internal operating matters, constitute areas where the accountant may offer services beyond the regular audit. It is also a good way in which to emphasize the extent of the audit. When weaknesses in the client's internal control have been the cause of extended audit procedures, the letter tells the reason for the necessarily larger tests and fee.

This type of letter can ordinarily be sent to the client at the conclusion of interim audit work. However audit work will occasionally disclose matters which require prompt corrective action by management to bring performance in some phase of operations to a satisfactory level. A timely management letter could be invaluable and demonstrates the auditor's concern with his client's welfare.

A verbal discussion of deficiencies in some area of internal control may not necessarily bring the desired result of instigating necessary reforms. A letter puts the accountant on record, which can obviate embarrassment at a later date. The management letter is also tangible evidence that work of importance to the client has been per formed. This could help to make the client more receptive to interim audit work, with unquestionable advantages to the CPA firm.

*Influence on Staff Development.* The fact that the auditor on the job is expected to supply information for the preparation of the management letter will condition him to a greater awareness of operating inefficiencies. This will lead to more constructive audits and to the development of auditors with broad viewpoints. Louis H. Pilie, CPA reports that one large local firm stated to him that: "By writing down the facts and recommendations, the partners are convinced that the preparer clarifies his own thinking, and can more logically relate it to all the problems and the solutions which he suggests."[2]

### THE FORM OF THE LETTER

The management letter should be written in a somewhat modified business letter style. It should have the usual letter heading but within the body of the letter underlined headings can be used with good effect to give emphasis to important areas discussed. It is vital that the letter retain simplicity and flexibility. Such letters do not lend themselves to standardization. The development of a uniform pattern such as has occurred with the long and short form reports will largely destroy their effectiveness.

The tone of the letter should be friendly and helpful. In offering criticism, tact and finesse should be used. It must be remembered that all weaknesses in business practices are a reflection upon employees at some level of management and it is important for the CPA to retain the goodwill

[1] John W. LaFrance, "Interpreting Reports for Management," *Journal of Accountancy,* February 1958, p. 60.

[2] *"Picked up along the Way,"* Louis H. Pilie, *The CPA,* March 1961, p. 4.

of every member of the management group so far as it is possible to do so and still discharge his responsibility as an auditor. It is, perhaps, a good policy, as it always is when offering criticism, to begin by complimenting the client for some outstandingly good management practice. For instance, it might be well to begin the letter with a statement (if true) that the company's procedures in general are excellent and to make clear that the matters discussed are exceptions.

Criticisms should be constructive and cover only matters of some importance. Inconsequential items and matters of purely individual opinion should be carefully excluded. Recommendations that are made must take into account the size and nature of the company and its organizational structure. Each management organization is a living structure composed of many individuals. Accordingly, even companies in the same industry differ widely. Management and operating suggestions, to be effective, must be made only with a thorough background knowledge of the particular company. Above all, the letter must be written only in the light of full knowledge and careful appraisal of the facts concerning the matter in question. Greatest care must be taken to avoid making unwarranted allegations. Perhaps the best way to sidestep these pitfalls is to have the auditor on the job review each apparent discrepancy with the party concerned. Disclosure of all facts and pertinent circumstances often leads to an interpretation entirely different from the auditor's first impression of a situation. In any event, the blow of harsh criticism can often be softened by including the explanation offered by the party responsible.

The letter should be addressed to an officer or executive group at a level sufficiently high to have the authority necessary to make corrective use of the information supplied. The person or persons addressed should not be in a position to have been functionally involved in the matter requiring attention. Generally the letter will be addressed to the chairman of the board or to the president of the company. If the letter contains information which management may wish to restrict, it should be labeled "confidential."

Where details have an important bearing on the matter under discussion, it is well to include only the highlights in the letter itself and to supply the detailed information in an attached memorandum. In this way the top level executive can quickly gain an overall grasp of the situation and read the details or not as he chooses. The details would, however, be supplied for the use of the officer at a lower level who must take action. Taking the size of the company involved into consideration a sufficiently large number of copies should be furnished to permit distribution within the company for use of the information at different management levels.

The letter should be signed by a partner of the CPA firm. Inasmuch as the letter seeks to achieve a friendly and personal tone, signing the firm name, as is common practice on audit reports, should be avoided. The partner having general supervision of the client's audit and other work should be the one to sign. A case could be made, perhaps, for having the senior auditor who actually performed the audit sign the letter but this would appear to lessen the importance placed upon the letter by the CPA firm and probably its impact upon the client.

## LETTER CONTENT

Matters included will undoubtedly cover a wide range of topics; presumably all will be constructive. A large proportion of the suggestions will be specific recommendations for necessary improvements in the internal control of various functions of the business. These criticisms are basic and should be of great importance to the well-being of the client, but to realize its full potential, the letter must do more. A conscious attempt must be made to foster a dynamic attitude towards the content of the management letter. The CPA, with his wide contact with many types of industrial companies, as well as broad coverage within a particular industry, is in an excellent position to bring a fresh viewpoint to bear upon his clients' problems. This informed, objective approach can be of great value to the client. Workable solutions to knotty problems observed at one company can have a ready application to those of another company.

The CPA firm must be on its guard that it does not violate the confidential relationship that exists with the client. Each management letter should be carefully reviewed before it is released to be sure that no suggestion to one client unwittingly disseminates another clients' methods or ideas that give the developing company a competitive advantage. The great majority of systems and procedures methods raise no such question of ethics for most can be found written up in systems magazines and in management text books.

The accountant's examination should cover the entire gamut of the company's operations; purchasing, shipping, receiving, storing, selling, manufacturing, administration and many other functions of the business. The American Institute of Certified Public Accountants has published a series of excellent studies on management services by CPAs. These offer a quite complete detailed coverage of subjects which may be covered in a management letter. Without attempting to offer an extensive listing of subjects here, I would like to mention some of the more unusual examples that have come to my attention.

*Random Illustrations.* New and unusual ideas which will increase the operating efficiency of a client's organization can be passed along through the management letter with resulting good will on the part of top management. For instance, the practice of maintaining several separate bank accounts, each to be used exclusively for successive weekly payrolls will substantially reduce the clerical costs involved in reconciling bank statements. Another device by which clerical costs may be substantially reduced is that of using envelopes addressed to different numbered post office boxes for receipts of payments from customers. A different P. O. box can be used for each subsidiary ledger. Receiving these documents already sorted according to the company's accounts receivable subsidiary ledger breakdown will result in cost savings greatly in excess of the price of the box rental. The distribution of this type of information involves no breach of confidence and will certainly go far to enhance the value of the accounting fee to the client.

Another important area for attention is that of planned scheduling for various functions of the business. The suggestion to schedule preventative maintenance may open new possibilities for production economies. A schedule for destroying records may go far to insure retention of all docu-

ments necessary to support a rigorous tax examination or to satisfy other governmental regulations. At the same time it may enable the company to cut storage costs and effect savings through more ready accessibility of the records which must be retained. A tax calendar is often worth many times the cost of its preparation in penalties avoided through its use. All large companies make use of an open purchase order file to assure delivery of materials so that production is not interrupted or sales lost due to being "out of stock." Smaller companies may be grateful to have such a system recommended.

With the current interest being shown concerning conflict of interest, designing a simple system of registering bids obtained and for scheduling periodic rebidding of all major items purchased will not only be useful to the company but will aid the auditor in his determination regarding purchasing management integrity. One national distilling company which had no provision for compulsory periodic rebidding found the omission very costly. No new bidding for printed labels had been secured for several years after the end of World War II. The internal audit staff discovered this and secured rebids. Not only was the price found to be high but new economies were found to have been developed by larger printing companies in producing colored labels. The final result was better than a 50% reduction in a very sizable annual printing bill.

A medium sized foundry was hard pressed to find working capital enough to meet its needs; in fact, it was financially insolvent. The auditor noted that there was a considerable balance of the accounts receivable long outstanding. At his suggestion, the president authorized a special examination of their invoicing and collection procedure. The cause of the delay in collections was quickly found to be a failure to meet customers' documentation requirements. Many of the large corporations and the United States Government demanded inspection certificates, special freight documents and specified numbers of invoices and shipping documents and other special requirements, which were not efficiently complied with. In addition, however, the study turned up other unsuspected delays in the cash flow to the business. Delays of several days were found in sending invoices to all customers. Both the large corporations and the Government permitted progress billing on large special order manufactured items. No such billings had been made. This foundry made many large and very expensive patterns for its customers. These also could be progress billed. Furthermore it was discovered that charges for pattern alterations and repairs were billed not only late but so haphazardly that many such costs were never invoiced to the customer. It is also interesting to note that when progress billing was set up for the expensive patterns, a substantial savings in insurance costs was enjoyed by the foundry, since, with the first progress payment, the pattern became the property of the customer and the risk of fire loss was theirs. This study resulted in the foundry strengthening both its profit position and financial standing.

During an audit of a manufacturing company, the owner told of his plans to enlarge the office building because of the need to hire more girls to keep up with company billing. The auditor felt that the number of personnel engaged in invoicing customers was about comparable to that of other like sized companies he audited.

He proposed and was authorized to look further into the situation. After his study, he recommended that billing be placed on an incentive payment plan. After struggling several months with various difficulties in securing employee acceptance of the new payment method, the number of typists needed for the work was cut in half. The girls made considerably higher individual salaries but total wages paid for the billing remained the same. The employer was able to cancel the plans for adding to the building and found an additional advantage in the greatly decreased employee turnover.

Many other interesting examples could be cited but those mentioned above are sufficient to illustrate the type of extra audit service that can be rendered business by the CPA. The management letter offers an excellent method of pointing out the need for special investigations and other services. At the conclusion of the special engagement, the results should be presented in writing. Again the management letter is the answer.

The management letter should present clear evidence that the audit was a dynamic one. What is meant by "dynamic" can best be explained by reference to such audit procedures with respect to a specific functional area. The audit of securities, naturally, must cover the accuracy of the statement presentation of asset value and related revenue, the application of accepted accounting principles in the recording of all transactions and the internal control procedures in effect to safeguard the securities. Following a dynamic philosophy would require that the scope of the audit be broadened to include an examination of the input-output efficiency of the company's investment policy. Such matters as the safety of principle, yield based upon current market value, and a diversification analysis by type of security and industry spread may well be included in the audit. The income tax implications of the company's security management should be examined and constructively criticized. Company policy with respect to investing excess funds should be reviewed and the loss of revenue or excess interest expense due to failure to closely supervise the cash balance should be pointed out. Substantial increases in net income can sometimes result from attention to these matters.

### CONCLUSION

One final word of caution—care must be taken that the CPA limit recommendations to those he is qualified to render. If this limitation is not observed the CPA jeopardizes both his personal reputation and that of the entire profession. In Montgomery's *Auditing* this is described as a rule of "fundamental importance." [3] This does not mean, however, that the CPA must be an expert in all fields in which he makes suggestions. He may in many cases discover and direct the client's attention to weaknesses or omissions that will require the advice of a specialist or the combined efforts of the company's own management. For instance, the auditor may suspect inadequate insurance limits on an insured property and recommend that the matter be reviewed by the company's insurance broker. Or, noticing the absence of an administrative organizational chart and some evidence of overlapping areas of managerial responsibility and other administrative malpractices, the CPA can certainly point out the

[3] Norman J. Lenhart & Philip J. Defliese, Montgomery's *Auditing*, 8th ed., Ronald Press, New York, p. 537.

omission of the chart and suggest that the company prepare one. The auditor's wide base of experience with many varied businesses, combined with a questioning attitude of mind, will often enable him to point out weaknesses in areas in which he is not an expert.

The CPA, in general, is more likely to err in being too conservative in venturing his criticism and offering assistance in business areas outside the accounting function. Most experienced CPAs are well qualified in varied business fields. Many accounting firms now have men who specialize in management services. To send these men to the client on a technical "scouting" basis would result in more intense management surveys. This could provide excellent material for management letters thereby creating good will with the client. Bringing these specialists into contact with the auditors and giving them the opportunity to read a management analysis of a situation with which they are familiar would assist in training staff members. Many times the management reports would result in additional revenues to the accounting firm through developing broader scope examinations and special service engagements.

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## The AICPA Examination Service and Its Administration Are Excellent

The CPA Examination Appraisal Commission is impressed very favorably by the manner in which the Uniform CPA Examinations are prepared and administered and by the way the Advisory Grading Service system is designed and executed. The examinations are well prepared and properly graded, and, in all probability, the grades reflect the competence of the candidates. The uniform examination service safeguards the profession against the induction of more than a nominal number of candidates with comparatively limited qualifications. In this way it protects the public interest while tending to build up in the public mind a highly favorable attitude toward certified public accountants as professionals.

## The Advisory Grading Service Is Eminently Fair to The CPA Examination Candidates

The survey of the Advisory Grading Service conducted by the Commission confirms that the service is conducted in a manner that is designed to be eminently fair to the CPA examination candidates. Every reasonable care is taken to provide that all papers are graded on a consistent basis.

REPORT OF THE CPA EXAMINATION APPRAISAL COMMISSION

# Walter A. Staub

(1881-1945)

*By* WILLIAM J. NEARY, CPA

Walter A. Staub, President of The New York State Society of Certified Public Accountants in 1933 and 1934, was during his forty-five year career in public accounting one of that distinguished group whose tireless and unselfish devotion to the advancement of the accounting profession has helped to bring it to its present level of competence, dignity and public service.

As a boy in his native city of Philadelphia, his road was not an easy one. Born on February 27, 1881, he was not yet five years of age when his father died. The family lived in very modest circumstances. At the age of nine he was admitted to Girard College, a school for fatherless boys founded by the merchant and philanthropist, Stephen Girard. He graduated with honors in 1897. This terminated his formal education but with a strong desire for knowledge he continued to study on his own. Throughout his life he maintained an active interest in Girard College and in 1934 was the recipient of the Stephen Girard award as one "whose outstanding qualifications in his chosen field of activity reflect credit and honor upon Girard College."

After graduation he took a position in the office of an electrical contractor and, in 1899, became an assistant to the accountant for the Girard Estate. In 1901, he came to the attention of Robert H. Montgomery who, three years earlier had, in association with William M. Lybrand, T. Edward Ross and Adam A. Ross, founded the firm of Lybrand, Ross Bros. & Montgomery in Philadelphia. Mr. Montgomery was impressed with the accounting knowledge and the mature judgment of this young man of twenty. In short order, Walter Staub became associated with the new firm, an association which was to last until his death almost forty-five years later.

The firm of Lybrand, Ross Bros. & Montgomery grew quickly and in 1908 Mr. Staub was assigned to set up and manage a new office in Pittsburgh. In 1911 he became a partner, the second partner to be admitted to the firm since its founding. At that time he assumed charge of the Chicago office. In 1914 he transferred to New York and was a resident partner there until his death.

In 1903, Mr. Staub passed the Pennsylvania CPA examination and received his certificate. In later years he became certified in a number of other states, including New York.

In 1904, the first International Congress of Accountants was held in St. Louis. Mr. Staub won the prize offered by the Congress for the best paper by a clerk in an accountant's office on "The Mode of Conducting an Audit." It is

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**This is one in a series of historical studies of outstanding figures and institutions of our profession. It was prepared under the auspices of our Society's Committee on History.**

noteworthy that in 1943 his winning paper was reprinted in THE ACCOUNTING REVIEW "because of its historical interest as the earliest authoritative description of the typical American audit program." This was the first of his many contributions to the literature of accounting. His "Income Tax Guide" which dealt with the Act adopted on October 3, 1913 was published in that year and was one of the first books written on federal income taxes. He contributed many articles to the JOURNAL OF ACCOUNTANCY, THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT and other publications on accounting and allied subjects. His contribution to the "Proceedings"—International Congress on Accounting held in New York in 1929, entitled "Consolidated Financial Statements" was later published in book form. He was a co-author of the books "Auditing Principles" published in 1924 and "Wills, Executors and Trustees" published in 1933.

Walter A. Staub was selected by the President and Fellows of Harvard College on recommendation of the Graduate School of Business Administration of Harvard University: ". . . a man recognized as outstanding in accounting, to serve for the academic year 1940-41 as the fourth Dickinson lecturer under the foundation established in acknowledgment of the debt of the accounting profession to Sir Arthur Lowes Dickinson." In August, 1945, a few months before his death, his excellent paper "Significance of the Balance Sheet—What is Book Value?" was written for THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT.

In addition to serving two terms as President of the New York State Society, he was First Vice President from 1930 to 1933 and also served as a Director. He was from 1941 to 1944 Chairman of the Committee on Accounting Procedure of the American Institute of Accountants. In 1935 he was Chairman of the joint committee appointed by the American Institute and the American Society of Certified Public Accountants to work out the plan which eventually resulted in the merger of the two organizations. As a recognized authority in the accounting and tax fields, Mr. Staub was much in demand as a speaker at meetings of various accounting societies, the Controllers Institute, the Practising Law Institute and similar organizations.

Although he gave unsparingly of his time and efforts for the welfare of the accounting profession, he found time for other activities. He served four elective terms on the Millburn, New Jersey, Board of Education from 1924 to 1936, the last several years as President. He was also Chairman of the Finance Committee of the Northern Baptist Convention and President of the Board of Trustees of Overlook Hospital in Summit, New Jersey.

Travel was Mr. Staub's chief form of relaxation. His interest in history led him to make numerous trips to Europe. He also traveled extensively in this country and Canada and to Hawaii. In sports, he enjoyed tennis and maintained a court at his home in Short Hills, New Jersey, where he lived with his wife, five sons and two daughters. Two of his sons are now partners in the firm of Lybrand, Ross Bros. & Montgomery.

Mr. Staub died suddenly on November 4, 1945 while on an overnight trip to his native city of Philadelphia. His passing left a void in his firm and in his profession. Nothing could better describe him nor express more clearly the loss felt upon his death than the following excerpt from a letter of tribute from one of the clients of his firm:

"It would be well nigh impossible for me to adequately express my deep regard for the high qualities of mind and heart with which his personality was endowed—he was indeed a rare character. He possessed in an unusual degree the most delightful faculties one could wish for—the faculty of subjecting a problem to a calm, dispassionate and highly intelligent analysis which gave to his judgment a quality that immediately won the admiration and support of his clients and his friends who detected and invariably appreciated the background of his broad experience and knowledge.

His endearing traits within a sterling character of the strictest personal integrity, provide a memory which will endear him and make that memory beloved by all who knew him."

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## The Shrinking Work Week

When Thomas Jefferson was president, the work week was almost eighty-five hours; by the end of the Civil War, it was a more humane seventy; and at the turn of the century, it had dropped to sixty. At the time of the 1929 crash, it was down to fifty; and now, thirty years later, it has contracted by another ten hours. Today's manufacturing employee works less than 2,000 hours a year, in contrast to 3,000 hours in 1900. Moreover, these 2,000 hours include paid holidays that were unknown to workers twenty years ago.

Just as our present work week creates discretionary income, leisure, too, is directly responsible for discretionary spending. It takes a prosperous country to support a market for second cars, boats, fishing tackle and paperback books. That is to say, people must work long enough hours to produce wealth for this market. On the other hand, ample leisure time is needed to make use of these products. The right balancing of work and leisure, therefore, is necessary to a thriving economy.

As a nation, we are often criticized for a prevailing materialism. We sometimes give the impression that our increasing leisure is simply an economic necessity to provide time for discretionary consumption as an end in itself. But our economy achieves much more. In a country with free institutions, no one can dictate the uses of leisure. When we take out our productivity gains in leisure, we are producing units of freedom in the fullest sense. No one publishes figures on the production of freedom, but one would guess that in this commodity, as in so many others, we outproduce other nations of the world.

Never before have masses of mankind known this freedom that abundant leisure confers. We have economists to study work and output, and we may need other specialists—perhaps a blend of economists and sociologists, as well as poets and philosophers—to study leisure.

Marion Harper, Jr., "The New Conflict of Time and Money," Business Horizons, Winter 1960

# State and Local Taxation

## NEW YORK STATE TAXATION

*Conducted by* PHILMORE H. FRIEDMAN, CPA

### TAXATION OF NON-RESIDENT PARTNERS AND EMPLOYEES

A somewhat surprising result is reached when we compare the extent to which a non-resident is subject to New York State income tax as a member of a partnership (doing business in New York) and as an officer of a correspondingly controlled corporation. Here is a hypothetical situation:

Partner A has a 5 percent interest in a partnership which has business offices in many states, including New York. He lives in Los Angeles and performs his services entirely in the partnership's Los Angeles office. Partner B also has a 5 percent interest in the partnership and lives in Connecticut but performs his services entirely in the New York office. The partnership's taxable income for its fiscal year ended July 31, 1961 was $200,000 of which 20 percent was determined to be allocable to New York. How much, if any, of the partnership income of A and B is subject to New York State income tax?

Partners A and B each will be subject to New York State income tax on partnership income of $2,000 (5% x $200,000 x 20%). This result is obtained under the rule that a non-resident is subject to New York State income tax on his distributive share of partnership income allocable to New York, whether such partner's services were performed in or outside of New York. For the purpose of determining a partner's distributive share of partnership income, the form of distribution is not material; whether the distribution is labelled salary, interest, or profits, according to the terms of an agreement or otherwise, it nevertheless constitutes partnership income. Thus, even if the distributive shares of the partnership income of A and B ($10,000 each) were represented entirely by salaries, their partnership income subject to New York State income tax would remain at $2,000.

Contrast the above result with that realized if the business were incorporated and A and B were officers of the corporation, with the same geographical location as to residence and place of employment. A non-resident employee is subject to New York State income tax only on income derived from sources within New York. Since A resides and works in California, he would not be subject to New York State income tax on his salary; B would be subject to New York State income tax on his entire salary since it will have been derived from services performed in New York.

It is also interesting to contrast the result if A and B were employees of the partnership for its year ended July 31, 1960, but partners at the fiscal year closing of July 31, 1961, assuming that all other facts remain the same. A would not be subject to New York State income tax in 1960 on his salary income of $10,000, but in 1961, $2,000 of his partnership income would be subject to New York State

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income tax. B would be subject to New York State income tax on his entire salary of $10,000 in 1960, but in 1961 only $2,000 of partnership income would be subject to the tax. This is so even if the partnership income of A and B in 1961 represents guaranteed salaries.

*Reciprocal Credits.* Another facet of the initial problem posed is the reciprocal credit provisions in the various states. New York and California have reciprocal tax credit provisions; therefore, Partner A would receive a credit against his New York State income tax for taxes paid on the same income to the state of California. Since Partner B is a resident of Connecticut, which state does not impose a partnership income tax, B would not be entitled to any credit against his New York State income tax. If Partner B were a resident of Massachusetts (rather than Connecticut) he would not be entitled to a credit against his New York State income tax for income taxes paid to Massachusetts because Massachusetts does not allow a reciprocal credit to New York residents. But if Partner B was a resident of New York and the partnership had income from Massachusetts, no credit would be allowed against Massachusetts tax for New York State income taxes paid; however, New York would allow a credit against the resident's New York income tax for Massachusetts income tax paid.

### EARNED INCOME OF NEW YORK RESIDENTS DERIVED FROM SOURCES OUTSIDE OF THE UNITED STATES

Section 911 of the Internal Revenue Code provides a full or partial exclusion from Federal gross income earned by citizens of the U. S. in foreign countries, under specified conditions. Since under the conformity legislation, the starting point in determining N. Y. adjusted gross income is federal adjusted gross income, such exclusion automatically is applicable for N. Y. personal income tax purposes. In this connection, Mario Borini, a member of the Society's Committee on N. Y. State Taxation, points out the requirements for the filing of N. Y. State income tax returns by N. Y. residents who qualify under the provision.

To ease the burden of compliance, the State Tax Commission has conformed substantially with the Federal rules with respect to the filing requirements of N. Y. residents who are entitled to claim, or who anticipate qualifying for such exclusion.

At the outset, we must recognize that in determining whether a N. Y. State income tax return must be filed, the exclusion granted under Section 911 is not considered. Thus, if the taxpayer's income for the taxable year is wholly excludable from federal and N. Y. adjusted gross income under the provisions of Section 911 of the Internal Revenue Code, he is nevertheless required to file a N. Y. personal income tax return, and must attach thereto a copy of Federal Form 2555 (Statement to support exemption of income earned abroad).

A taxpayer is granted an automatic extension of two months for filing a N. Y. personal income tax return if he is abroad on the date his return is due. A statement showing that the taxpayer was resorting or travelling outside the U. S., and the filing date, must be attached to the return. Where a N. Y. resident does not qualify for exemption under Section 911 at the due date of the return, but ultimately expects to so qualify, he may obtain an extension of time within which to file the N. Y. State income tax return. The N. Y. extension may be obtained, however, only if a similar extension has been requested for the Federal income tax return. An extension will be granted to a date after the time requirements

of Section 911 are satisfied.

If tax is due with the return (even after qualifying for an exemption under Section 911) it may be advisable for the taxpayer to file by the original due date of the return. The reason is that interest at the rate of 6% per annum is charged on the unpaid tax from the regular due date of the return to the date the tax is paid. If a return is filed before the exemption becomes effective. all gross income from both the U. S. and foreign sources must be reported therein. Upon later qualifying for the exemption of income under Section 911 a claim for refund of tax on Form IT-113 should be filed. If a N. Y. resident, in lieu of requesting the extension, files a federal income tax return before he qualifies for the "earned income exclusion," he is also required to file a N. Y. State personal income tax return, and may not request an extension of time to file the return because of the possible future application of Section 911.

Employers are not required to withhold N. Y. State income taxes on the excluded income provided the Federal income tax similarly is not required to be withheld. However, the employer must retain for a period of six years a copy of the federal statement filed by the employee supporting the exclusion.

It should be noted that the President's tax program includes a recommendation that the exclusion granted under Section 911 for income earned abroad be limited to the less developed countries. Further, the exemption available for a bona fide resident of a foreign country would be limited to a maximum exemption of $20,000 per year. If enacted into law, present indications are that this recommendation would apply to taxable years beginning after December 31, 1961. Any change in the Federal income tax in this respect automatically will be adopted by N. Y. State under the conformity definitions.

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## STATE TAXATION, OTHER THAN NEW YORK

*Conducted by* S. ZACHARY SCHEER, CPA

### TAX COLLECTIONS FROM NONRESIDENT CORPORATIONS

Based upon decisions of the past few years, states may, under given circumstances, impose taxes on foreign corporations doing interstate business. Having levied a tax against a foreign corporation, the state must find the means with which to collect it.

In prior years most states would not undertake the enforcement of the laws of another state and would therefore not permit suits for collection of taxes due another state. This restriction has changed considerably. There are at present 27 states that have reciprocal tax collection statutes allowing any state or political subdivision the right to sue in its courts for recovery of taxes when a like right is allowed by the state bringing such suit.

### AVERAGE VALUE METHOD FOR ASSESSING TANGIBLE PERSONALTY

The Ohio Board of Tax Appeals ruled in a recent case (*Beerman*

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*Stores, Inc.* v. *Bowers*) that average month-end inventories may be used only if the taxpayer has some tangible personal property in the taxing district on tax-listing day. In the instant case, the taxpayer's ready-to-wear store was completely destroyed by fire before tax-listing day, February 1, 1958, and therefore had no tangible personalty in the taxing district on that day.

CONNECTICUT OMNIBUS TAX BILL APPROVED

Among the major changes approved in this bill are an increase in the Corporation Business Tax rate from 3¾% to 5% for income years beginning in 1961; and an increase in the Sales Tax rate from 3% to 3½%, effective July 1, 1961.

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## MUNICIPAL AND LOCAL TAXATION

*Conducted by* ROBERT I. EDELSON, CPA

AMENDED NEW YORK CITY GROSS RECEIPTS TAX REGULATIONS

A prior column discussed recent additions to local law, involving substantial changes in the New York City Gross Receipts Tax. The Comptroller has issued some amended regulations (effective July 1, 1961) reflecting these changes. A few of these regulations are briefly discussed.

*Extensions.* Under Article 112 the Comptroller or Treasurer may grant an extension not to exceed sixty days, and written application for such extension must be received no later than fifteen days prior to the due date of the return.

If the extension of time is granted, the taxpayer must file a tentative return on or before the due date, with remittance of the tax estimated to be due. This tentative return should state the amount of tax estimated to be due without showing the amount of receipts or gross income.

*Notarial Seal Not Required.* Article 115 eliminates the requirement that returns be sworn to before a notary public. However, returns for privilege periods ending on June 30, 1961, must still be under oath. This article also provides that the return of a copartnership must be signed by any partner thereof. The old article required the signature of a general partner.

*Refunds Made Easier.* With respect to all taxes due and paid prior to April 21, 1957, a refund could be obtained only if the tax was paid under written protest made at the time of payment of tax, and application therefor was made within one year from the date of payment of the tax.

With respect to all taxes due or paid after April 20, 1957, the requirement of payment under protest is eliminated. Article 122, as amended, contains many other changes, and merits study by practitioners.

*Other Amendments.* The following amended regulations were also issued by the Comptroller:

- Article 104—covering privilege and base periods.
- Article 111—covering the filing of returns and payment of tax.

NEW AMENDMENT—GROSS RECEIPTS TAX

A new regulation, Article 105a,

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sets forth the rules governing base periods for privilege periods beginning July 1, 1961. These regulations are lengthy and detailed. Practitioners will find it advisable to study them in their entirety.

### TRADE-IN RULE IN N. Y. CITY SALES AND USE TAX UPHELD

In the case of *Spatt* v. *City of New York,* (Supreme Court, Appellate Division, Second Judicial Department) Regulation Article 42 was upheld. Article 42 of the Sales and Use Tax Regulations provides that for sales tax purposes, the sales tax is to be computed after deduction of the trade-in allowance, but for purposes of the compensating use tax, the use tax is to be computed on total selling price of the property sold without any allowances for the property accepted in trade.

A resident of New York City had brought an action "to declare unconstitutional and void" this part of the New York City Sales and Use Tax Regulations, and "to enjoin defendants from collecting a use tax on the value of an automobile traded in upon plaintiff's purchase of a new automobile outside the city limits."

A lower court had upheld the taxpayer's position, but the Appellate Division found in favor of the City of New York, holding that Article 42 does not violate the equal protection clause of the United States Constitution, and that the distinction between sales and use taxes is justified.

The court found this distinction justifiable on three grounds:

- Encouragement of sales within the City.
- Greater cost of enforcing the use tax.
- Differing probabilities of resale of the trade-in automobile within and without the City.

# Accounting and the SEC

*Conducted by* Louis H. Rappaport, CPA

## RELEASE FROM OBLIGATION UPON PAYMENT OF CONSIDERATION BY A PRINCIPAL SHAREHOLDER: THE HAZEL BISHOP CASE

In June, 1960, Hazel Bishop, Inc., a company engaged in the cosmetics business, filed a registration statement[1] with the SEC under the Securities Act of 1933. The registration statement related to shares already outstanding which might be offered to the public by the selling shareholders. In October, 1960, the registration statement was amended, and shortly thereafter the Commission began proceedings to determine whether a stop order should be issued suspending the effectiveness of the registration statement and preventing the sale of the securities to the public. After the stop order proceedings were started, the company filed further amendments to its registration statement on March 6, April 3, and April 17, 1961.

One of the principal issues in the stop order proceedings related to the financial statements, including the summary of earnings. The SEC alleged that the summary of earnings was "deceptive and misleading" in several respects. In at least one respect the facts (and the SEC's interpretation of the financial and accounting implications in those facts) will be read with interest by accountants and others interested in accounting.

In May, 1958, Raymond Spector, who owned 542,000[2] shares of Hazel Bishop's common stock (about half of the shares then outstanding) and 98,000 shares of convertible preferred stock (the entire issue) sold all of his stock to a company now known as Television Industries, Inc. ("TVI"). The contract of sale provided that TVI was to pay for the shares purchased over a period of ten years.

At about the same time Hazel Bishop agreed to purchase television "spot" advertising time from TVI and to make monthly cash payments therefor. By October 1959, Hazel Bishop owed TVI $1,110,000 under this agreement.

About that same time, Hazel Bishop was in urgent need of additional working capital, and a complicated series of transactions was effected which, within the space of a few months, resulted in the company receiving $2,400,000 in cash and a release, without any payment by the company, of its entire obligation to TVI.

Readers interested in the precise nature and details of the transactions are referred to the SEC release[3] itself. So far as it relates to the subject of our immediate interest, the pertinent transactions were these:

**LOUIS H. RAPPAPORT, CPA, a partner in the firm of Lybrand, Ross Bros. & Montgomery, CPAs, is the author of SEC ACCOUNTING PRACTICE AND PROCEDURE.**

[1] SEC File No. 2-16761.

[2] For convenience, all amounts are approximate.

1. Spector and TVI rescinded their 1958 agreement, TVI returning to Spector the common and preferred stocks of Hazel Bishop formerly owned by Spector, and Spector repaying or agreeing to repay all sums which TVI had paid on account of the purchase price of such shares;
2. TVI waived payment of its claims against Hazel Bishop for advertising *without any payment by Hazel Bishop;* and
3. Spector agreed *to transfer to TVI 150,000 shares of Hazel Bishop common stock owned by Spector.*

Hazel Bishop's indebtedness to TVI for advertising was $1,110,000. Of this amount, $935,000 was applicable to the fiscal year ended October 31, 1959 and $175,000 to the preceding fiscal year. In the summary of earnings as originally filed, advertising expenses for fiscal 1958 and 1959 were reduced in the aggregate by $1,110,000, representing the amount owed to TVI for advertising which was forgiven without payment of any consideration by Hazel Bishop. The SEC said this presentation was deceptive and misleading because "operating costs for 1958 and 1959 had been relieved of material amounts of advertising expenses incurred by registrant and presumably necessary to produce the sales volume shown."

Spector, it will be recalled, transferred 150,000 shares of his common stock to TVI in settlement of Hazel Bishop's entire obligation to TVI. A value of $675,000 was attributed to the stock so transferred. The financial statements were amended to reflect this amount ($675,000) as a capital contribution by Spector. The difference between $675,000 and the amount of the claim ($1,110,000), that is, $435,000, was treated as a reduction in advertising costs for 1958 and 1959. These and other adjustments had the effect of transforming a profit as originally reported of $102,000 for 1959 into a loss of $707,000.

In short, the view taken by the company in its revised financial statements, and concurred in by the SEC, was that consideration had been given for the release of TVI's claims. The consideration was felt to be the fair value of the 150,000 shares of stock. This amount represented an indirect capital contribution by a principal shareholder rather than a reduction of advertising expense.

On the basis of the revised financial statements, the stop order was subsequently lifted and the registration statement permitted to become effective. THE END

[3] Release No. 4371 under the 1933 Act, dated June 7, 1961.

# Administration of A CPA Practice

*Conducted by* MATTHEW P. GERAGHTY, CPA

MODERNIZATION OF STAFF TITLES

Some people may concur with Shakespeare in belittling the importance of a name. However, names can have an important psychological impact, and if the impact, if any, is unfavorable, it may be well to consider changing to a more desirable name.

In our profession the titles junior and semi-senior accountants are traditional. However, there is good reason to believe that they are now obsolete, do not rest well with the lower echelon staff men, and that they are responsible for some client relation problems as well as recruiting difficulties.

There is a move underway to effect a modernization of these classifications. In fact, some firms have already discontinued the title junior accountant. The modernization may also have the effect of simplification, too, inasmuch as it eliminates lines of demarcation that often are difficult to define and support. What is the dividing line between a junior and a semi-senior? It can't be years of service alone because, personality competence, prior experience and schooling will move some young men ahead much faster than others.

**MATTHEW P. GERAGHTY, CPA, is Chairman of the Committee on Administration of Accountant's Practice of The New York State Society of Certified Public Accountants. He is a partner in the firm of Alexander Grant & Company, CPAs.**

An editorial in the June 1961 issue of *The California CPA* urges that these classifications be abolished. Your editor is fully in accord and recommends as replacements just two categories, namely

Senior or In-Charge Accountant
Staff Assistant

The editorial makes one point that is worthy of the most serious consideration, touching upon the impact of titles on the staff recruiting problem.

"Is it possible that the title junior and what it seems to imply may be a deterrant to young men and women taking a look at the public accounting profession as a possible choice for a career? Is it possible that those who choose public accounting find it embarrassing to tell their families, friends and former classmates that they are juniors?"

INSURANCE COVERAGE FOR PUBLIC ACCOUNTING FIRMS

Because of the pressure of their work and the priorities given to clients' needs, public accounting firms are apt to ignore some of their own business needs, or at best to give them secondary consideration. One of such needs is adequate insurance coverage. As an aid in reviewing a firm's insurance coverage, a brief description of one firm's insurance program, excluding life, health and workmen's compensation coverage, is described here.

*Accountants' Indemnity Insurance.* This policy indemnifies a firm against

any claim or claims made against it during the period of the policy by reason of any negligent act, error or omission whenever and wherever the act or omission may have been committed on the part of the firm or any person now or hereafter to be employed by the firm during the term of the policy, in or about the business conducted by the firm in its professional capacity as Certified Public Accountants. This policy includes protection against claims for liability under the Securities Act of 1933. The premium is based upon the number of employees.

*Comprehensive General Public Liability.* Under this policy the insurance company agrees to pay all sums which it shall become legally obligated to pay as damages because of bodily injury, sickness or disease, including death, at any time, resulting therefrom, sustained by any person and caused by accident. This policy does not cover the firm for any injury caused to an employee or for liability in connection with the use of automobiles. It does however, cover risks normally included under an owner's, landlord's and tenant's liability policy.

*Valuable Papers Insurance.* The coverage of this policy includes reports and working papers while in the mails or in the hands of express agencies. Therefore, working papers mailed between offices require only registration to establish proof of loss. No excess valuation is required in sending material through the mails.

The policy provides protection against all risks or loss or damage to books, records, working papers or any similar papers which are the property of the firm or of its clients or others and for which the firm is legally responsible. The policy will pay for the actual cost of reinstating or replacing the lost material.

*Fidelity Bond.* This bond protects the firm against loss of money or other property belonging to the firm, or in which the firm has a pecuniary interest, or for which the firm is legally liable because of any fraudulent or dishonest act committed by any one or more employees. In addition it covers any loss sustained by a client of the firm through any fraudulent or dishonest acts of the employees of the firm.

*Nonownership Automobile Liability.* This policy covers the legal liability resulting from employees using their personally-owned automobiles on firm business. It does not cover liability in connection with partners' personally-owned automobiles. The policy includes both bodily injury coverage and property damage.

*Fire and Extended Coverage.* This policy, giving due regard to the co-insurance clause contained therein, provides protection from loss due to fire and covers the contents of the office including furniture, equipment, leasehold improvements and supplies.

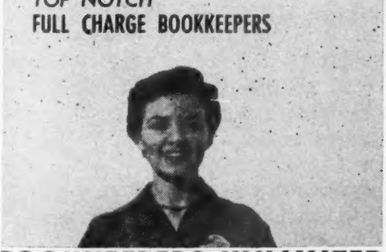
*Partners' Individually-Owned Automobiles.* Each partner carries automobile liability insurance at his own expense covering himself and the firm for bodily injury liability and property damage liability. The insurance coverage is written to cover the firm's fiscal year.

*Firm Outings, Picnics.* A one-day policy is obtained to cover accidents and injuries that might occur during firm outings, picnics or other gatherings. This policy covers the partners, employees and guests of the firm for loss resulting from injuries sustained while traveling from their homes or place of business to the gathering, during the gathering and while returning to their place of business or residence. The policy is usually written for the period from 5:00 A.M. of the day of

the affair to 5:00 A.M. of the following day. The policy covers the payment of specified amounts for loss of life, limbs or eyes, and the actual medical, surgical or hospital bills, but not in excess of a stated amount per person.

All policies are written to coincide with the firm's fiscal year. THE END





# Payroll Tax Notes

*Conducted by* SAMUEL S. RESS, CPA

### CHANGES MADE BY SOCIAL SECURITY AMENDMENTS OF 1961

The following major changes in Old-Age, Survivors and Disability benefits and taxes were made by the Social Security Amendments of 1961.

### RETIRED MEN MAY COLLECT OLD-AGE INSURANCE AT 62

Starting with August 1961, men between 62 and 65 years of age may collect old-age insurance, at reduced amounts, provided they would have been otherwise eligible for benefits had they been 65 or over. The amount of the reduction is five-ninths of one percent for each month a benefit will be paid before the claimant reaches age 65. The reduced benefit rate continues after the claimant attains age 65, except that at age 65 his benefit rate may be recomputed to take into account earnings and Social Security contributions after benefits became effective.

*Status of Wife.* The wife of a claimant who is under 65 will continue to be eligible for a wife's insurance benefits at age 62 but her benefit rate will be one-half of what her husband's benefit rate would have been at age 65, scaled down by twenty-five thirty-sixths of one percent for each month that she is under 65 when her benefit starts.

*Status of Dependent Husbands and Widowers.* Dependent husbands and dependent widowers likewise become eligible to apply for Social Security benefits starting at age 62. The benefit rate in such cases is scaled down in the same way that a wife's benefit is reduced under the old law upon applying for benefits prior to attaining age 65. A widower's benefits at age 62 as in the case of a widow at age 62 are not scaled down.

Full-rate benefits are also payable to a dependent, 62 year old surviving father of a working son or daughter who has died.

*Status of Children's Benefits.* There is no scaling down of benefits, despite an earlier retirement, in the case of benefits payable to children under 18 or to children over 18 who have been severely disabled since childhood. They continue to collect one-half of the father's benefit rate as if he had retired at age 65.

### EXTENSION OF FILING DATE FOR DISABILITY CLAIMS

The deadline for filing claims for disability benefits by persons disabled for several years past in behalf of dependents and themselves has been extended to June 30, 1962.

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**SAMUEL S. RESS, CPA, is engaged in public practice in New York City. Dr. Ress was formerly a member of our Society's Committee on New York State Taxation and chairman of its Subcommittee on Unemployment Insurance. He is a member of the Committee on Municipal and Local Taxation.**

## SOCIAL SECURITY TAXES INCREASED STARTING 1962

Under the new law, beginning January 1, 1962, social security tax rates for employers, employees and the covered self-employed will be as follows:

| Calendar Years | Employer Tax Rate | Employee Tax Rate | Quarterly F.I.C.A. Total Rate | Annual Self-Employed Tax Rate |
|---|---|---|---|---|
| 1962 | .03125 | .03125 | .0625 | .047 |
| 1963-1965 | .03625 | .03625 | .0725 | .054 |
| 1966-1967 | .04125 | .04125 | .0825 | .062 |
| 1968 and after | .04625 | .04625 | .0925 | .069 |

## AGED WIDOW'S BENEFITS INCREASED

The widow's or widower's benefit rate at age 62 is raised from 75% to 82.5% of what the deceased spouse would have received at age 65 if alive at that time. Similarly an increased benefit will be given a parent receiving dependent's survivor's benefits derived from the earnings of a predeceased son or daughter upon whom the one surviving parent had been dependent for support.

## MINIMUM BENEFIT RATES ARE INCREASED

Forty dollars a month is the lowest benefit rate payable to eligible claimants at age 65, with a lower rate payable to persons retiring at age 62 or thereafter. The minimum survivors' insurance payable to two or more survivors who had been dependent upon the deceased wage-earner for support is raised to a minimum of $60 for such dependent survivors.

## EARNINGS PERIOD FOR ELIGIBILITY REDUCED

To determine how many calendar quarters of coverage are required for one to become eligible for benefits, the following table prepared by the Social Security Administration may be used for reference.

| Claimant's Year of Birth | Quarters of Coverage Needed | | Claimant's Year of Birth | Quarters of Coverage Needed | |
|---|---|---|---|---|---|
| | Men | Women | | Men | Women |
| 1892 or earlier | 6 | 6 | 1905 | 19 | 16 |
| 1893 | 7 | 6 | 1906 | 20 | 17 |
| 1894 | 8 | 6 | 1907 | 21 | 18 |
| 1895 | 9 | 6 | 1908 | 22 | 19 |
| 1896 | 10 | 7 | 1909 | 23 | 20 |
| 1897 | 11 | 8 | 1910 | 24 | 21 |
| 1898 | 12 | 9 | 1911 | 25 | 22 |
| 1899 | 13 | 10 | 1912 | 26 | 23 |
| 1900 | 14 | 11 | 1913 | 27 | 24 |
| 1901 | 15 | 12 | 1917 | 31 | 28 |
| 1902 | 16 | 13 | 1921 | 35 | 32 |
| 1903 | 17 | 14 | 1925 | 39 | 36 |
| 1904 | 18 | 15 | 1929 and later | 40 | 40 |

## EXAMPLES OF MONTHLY PAYMENTS BEGINNING AUGUST 1961

| Average yearly earnings after 1950 | $800 or less | $1200 | $1800 | $2400 | $3000 | $3600 | $4200 | $4800 |
|---|---|---|---|---|---|---|---|---|
| Retirement at 65 Disability benefits | $40.00 | 59.00 | 73.00 | 84.00 | 95.00 | 105.00 | 116.00 | 127.00 |
| Retirement at 64 | 37.40 | 55.10 | 68.20 | 78.40 | 88.70 | 98.00 | 108.30 | 118.60 |
| Retirement at 63 | 34.70 | 51.20 | 63.30 | 72.80 | 82.40 | 91.00 | 100.60 | 110.10 |
| Retirement at 62 | 32.00 | 47.20 | 58.40 | 67.20 | 76.00 | 84.00 | 92.80 | 101.60 |
| Wife's benefit at 65 or with child in her care | 20.00 | 29.50 | 36.50 | 42.00 | 47.50 | 52.50 | 58.00 | 63.50 |
| Wife's benefit at 64 | 18.40 | 27.10 | 33.50 | 38.50 | 43.60 | 48.20 | 53.20 | 58.30 |
| Wife's benefit at 63 | 16.70 | 24.60 | 30.50 | 35.00 | 39.60 | 43.80 | 48.40 | 53.00 |
| Wife's benefit at 62 | 15.00 | 22.20 | 27.40 | 31.50 | 35.70 | 39.40 | 43.50 | 47.70 |
| Widow 62 or over | 40.00 | 48.70 | 60.30 | 69.30 | 78.40 | 86.70 | 95.70 | 104.80 |
| Widow under 62 and 1 child | 60.00 | 88.50 | 109.60 | 126.00 | 142.60 | 157.60 | 174.00 | 190.60 |
| Widow under 62 and 2 children | 60.00 | 88.50 | 120.00 | 161.60 | 202.40 | 236.40 | 254.00 | 254.00 |
| One surviving child | 40.00 | 44.30 | 54.80 | 63.00 | 71.30 | 78.80 | 87.00 | 95.30 |
| Two surviving children | 60.00 | 88.50 | 109.60 | 126.00 | 142.60 | 157.60 | 174.00 | 190.60 |
| Maximum Family Benefit | 60.00 | 88.50 | 120.00 | 161.60 | 202.40 | 240.00 | 254.00 | 254.00 |
| Lump Sum Death Payment | 120.00 | 177.00 | 219.00 | 252.00 | 255.00 | 255.00 | 255.00 | 255.00 |

**U. S. DEPARTMENT OF HEALTH, EDUCATION, AND WELFARE**
**Social Security Administration**

**July 1961**

### WORKING SOCIAL SECURITY CLAIMANTS UNDER AGE 72

Under the old law a beneficiary under age 72 may earn $1,200 or less in a year and receive all of his social security benefits, but if he earned from $1,200 to $1,700 he will lose $1 in benefits for each $2 he earns in either wages, or self-employment income, or both. One dollar will be withheld in benefits for each dollar earned over $1,700 beginning with 1961. However, there is no change in the provision that regardless of annual earnings, a claimant may be entitled to a check for any month in which he neither earns more than $100 in wages nor performs substantial services in self-employment. No earnings' limitations continue for age 72 claimants.

### IMPROVED STATUS OF ILLEGITIMATE CHILDREN'S BENEFITS

Survivor insurance benefits previously denied certain illegitimate children are now available to them as a result of a 1961 amendment[1] of the state law. The Social Security Administration had previously refused benefits to children from second marriages where the first marriage of one spouse had not been lawfully dissolved. Many of these situations arose where one or both parents of the child benefit claimant, had obtained a divorce that New York State did not recognize because of lack of jurisdiction by the court granting such decree as in the cases of certain "Mexican" or out of state divorces.

[1] Chapter 843 of the Regular Session Laws of 1961 effective April 17, 1961.

# Federal Taxation

*Decisions and Rulings*—RICHARD S. HELSTEIN, CPA

*Commentary* —Committee on Federal Taxation
Chairman, ARTHUR J. DIXON, CPA

## DECISIONS AND RULINGS

### PREPAID INCOME: THE A. A. A. DECISION

Attempting to distinguish its case from that of the *Automobile Club of Michigan* (S. Ct. 1957, 353 U. S. 180) on the grounds that in the instant case there was proof which was missing in the earlier case, the American Automobile Association tried anew to convince the Supreme Court that prepaid dues should be reported as income when they are earned and not in the year they are received. It failed—by 5 to 4.

The A. A. A. based its claim upon the fact that the Court record contained expert accounting testimony indicating that the method used in determining the deferral of prepaid dues was in accordance with generally accepted accounting principles i.e., that the experience of the taxpayer which was revealed in its detailed "cost of member service" showed the correlation between service cost and the period over which the dues were reported as earned.

The Court refused to accept this argument, stating that the holding upon which its decision was based in the prior case was that the system of accounting was purely artificial because "substantially all services are performed only upon a member's demand and the taxpayer's performance was not related to fixed dates after the tax year." That finding, the Court said, is also true in the instant case.

The Court stated that a finding by the Court of Claims that the method of accounting "was in accord with generally accepted commercial accounting principles and practices," does not indicate that it so clearly reflects income as to be binding upon the Treasury. It pointed out that Congress had enacted in 1954 sections specifically covering this situation (Sections 452 and 462) and a year later repealed them. Then in 1958 Congress had added Section 455 which allows publishers to defer prepaid subscriptions, at the same time specifically refusing to include automobile clubs in such provision. This, concludes the Court, is clear evidence that Congress did not intend the prepaid dues to be deferred (*American Automobile Association* v. *the U. S.,* S. Ct. 6/19/61).

On the same day, the Supreme Court vacated and remanded the decision of the Eighth Circuit Court of Appeals in the case of *Mark E. Schlude* v. *Com.* (reported in NYCPA, December 1960,

p. 856) for reconsideration in the light of its A. A. A. decision.

### CASH BASIS TAXPAYER'S ACCOUNTS RECEIVABLE NOT PROPERTY UNDER SECTION 337

Section 337 was inserted into the 1954 Code to avoid a double-tax in cases where a corporation, in the process of liquidation, sells property at a gain. The section taxes the gain at the stockholder level upon liquidation by providing that no gain shall be recognized to the corporation. However, the Code further provides that a sale of inventory and installment obligations shall produce recognized income to the corporation by excluding such assets from the definition of the word "property." This, obviously, was to avoid the conversion of ordinary income to capital gain. (There is an exception to this as set forth in Section 337(b)(2), in the case of a bulk sale, but it is not pertinent here.)

The Tax Court has attempted to preserve the Congressional intent by holding that accounts receivable of a cash basis taxpayer are installment obligations within the intent of Section 337(b)(2) and therefore are not "property," the gain on the sale of which is not recognized under Section 337(a).

The Court explained that accounts receivable of a cash basis corporation were essentially equivalent to installment obligations in that the tax upon a sale is postponed until payment shall be received. Accordingly, a cash basis corporation, by selling its accounts receivable during the twelve-month liquidation period, may not thereby convert ordinary income into capital gain which is taxed only to the stockholder upon distribution of its assets in liquidation. (*Family Record Plan Inc.* 36 TC...... No. 33).

This holding is not at all unexpected, and was predicted in a discussion of Rev. Rul. 59-120 in this column at page 538, issue of July 1959.

### PAYMENTS PURSUANT TO SECTION 16(B) OF THE SECURITIES EXCHANGE ACT OF 1934 ARE DEDUCTIBLE

Section 16(b) of the Securities Exchange Act of 1934 provides that, for the purpose of preventing the unfair use of information which may have been obtained by an officer, director or beneficial owner of more than 10 percent of the stock of a corporation, any profit realized by him on the purchase and sale (or sale and purchase) within six months, of the equity securities of such corporation shall be returned to the corporation.

The Commissioner had previously held that the repayment of the profits on the trading was in the nature of a penalty and therefore was not deductible for tax purposes (although the profit was to be reported), since such a deduction would frustrate public policy. (I.T. 4069, 1952-1 CB 28 based on *William F. Davis* 17 TC 549).

However, in view of the decision in *Laurence M. Marks* 27 TC 464 the Commissioner has reconsidered. In the *Marks* case a taxpayer returned the profits he earned on the trading of the stock of a corporation in which he was a stockholder and director in order to avoid any litigation or reflection upon his business reputation, even though his own firm was a dealer in the securities of the corporation involved.

Reasoning that Section 16(b) does not characterize the dealings as unlaw-

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ful nor the repayment as a penalty, and that further, no distinction is made as to whether the profits were innocently derived, the Commissioner has now ruled that the effect of Section 16(b) is to place the insider in the position he occupied before the transaction. Accordingly, the repayment shall be deductible, and the "income tax significance of the capital stock dealings giving rise to the payment determines whether it is deductible as an ordinary loss or as a capital loss." (Rev. Rul. 61-115, IRB 1961-25, 7).

### ODD CASUALTY LOSSES

It has been said that if one million monkeys were to type on one million typewriters for one million years one of them would produce "Hamlet." Thus, it would seem that all things shall come to pass in due time. We have already had a claim litigated in the Tax Court that a taxpayer suffered a deductible casualty loss when his horse died from eating the silk lining of a hat. The Court agreed that this might be a casualty loss, but disallowed the loss because it was not convinced that the cause of death was the eating of the lining and not influenza. (*McMorran* BTA Memo. Op. 1939)

We now find that the destruction of one of a pair of valuable vases by a neurotic Siamese cat during one of its fits does not qualify as a casualty loss because it is not similar to a fire, a storm, or a shipwreck. (*J. Raymond Dyer* TC Memo 1961-141).

## COMMENTARY

### CAUTION NEEDED TO DISTINGUISH LEASEHOLD SALE FROM SUBLEASE

The line distinguishing a sale of a leasehold from a mere sublease of the premises is not too clearly defined. *Voloudakis,* 274 F(2d) 209 (9th Cir. 1960) illustrates some pitfalls which may result in the characterization of a purported sale as a sublease, with adverse tax consequences.

In the *Voloudakis* case a right of reentry in the event of the default of the new occupant was retained by the taxpayer. Although the Court, in a footnote, recognized the conflict of authorities as to whether a power to reenter in and of itself results in a sublease, this factor, when coupled with the fact that the instrument (which used such term as "lessor" and "lessee"), was in form a lease, resulted in a finding that the transaction was a sublease and not a sale.

If the sale of a leasehold, rather than a sublease is desired, the *Voloudakis* case presents guidelines which should be followed in order to achieve this objective:

- Preliminary negotiations should be conducted against a background of a sale, not a sublease;
- The instrument should unambiguously be a sale in form;
- The instrument should transfer all rights of the original lessee;
- Any right to reentry should be avoided;
- Notes, preferably interest-bearing, should be used to emphasize that the seller is looking only to the collection of the purchase price;
- The original lessee should not participate in any subsequent modification of the lease.

Ordinarily the sale of a leasehold on commercial space which has been held for more than six months will result in a long-term capital gain or loss. Leaseholds with less than 30

years to run are capital assets as they do not fall within any of the "exception" clauses in Section 1221. Such leases are not real property and Reg. Section 1.162-11(a) makes clear that amortization of the cost thereof is deductible as a business expense under Section 162 and not as depreciation under Section 167.

Revenue Ruling 60-4 states that leaseholds with 30 or more years to run are included in "property used in the trade or business" as defined in Section 1231(b). This conclusion is based on the principle that such leases constitute real property. It has long been embodied in the Regulations governing non-taxable exchanges of property held for productive use or investment, now Section 1031. The practical significance of this distinction is that the gain from the sale of a long-term lease will be reduced by other net losses described in Section 1231(a) before the favorable capital gain tax rate is applied. On the other hand, the gain from the sale of a lease with less than 30 years to run is a capital gain without application of Section 1231 and would not be reduced, for example, by net losses from sales of machinery held for more than six months.

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**DISQUALIFYING DISPOSITION OF STOCK ACQUIRED UNDER RESTRICTED STOCK OPTION BY CITIZEN EMPLOYED ABROAD**

Three months ago we considered the situation of an employer whose employee had made a "disqualifying disposition" of stock acquired pursuant to a restricted stock option. It was pointed out that, although generally no deduction is allowed to the corporation with respect to a restricted stock option, a disqualifying disposition will give the corporation a deduction which is probably measured by the difference between the value of the stock at the time acquired and the option price.

The other aspect of a disqualifying disposition is that the employee is deemed to have realized ordinary income in an equivalent amount. The Regulations under Section 421 confirm the logical inference that this income is in the nature of compensation.

Suppose that A is a U. S. citizen who is a bona fide resident of a foreign country and who has been employed by Corporation X only outside the United States. A has just acquired stock through the exercise of a restricted stock option. If A holds his stock until after two years from the date of the granting of the option, and after six months from the transfer of the shares to him, he will realize long-term capital gain measured by the excess of the selling price over the option price.

If, however, A makes a disqualifying disposition by selling his stock immediately after acquisition, he will realize compensation, probably measured by the excess of the fair market value at the time acquired over the option price. Application of Section 911(a) results in the logical conclusion that this amount of compensation will be excluded from A's gross income. Pursuant to the principles for

determining basis, A's tax cost for the stock should be the fair market value at the time of its acquisition. Thus, by means of a disqualifying disposition, A is able to avoid the U.S. capital gains tax which he would have had to pay if he had held the stock for the qualifying periods. Furthermore, A's unique tax position should not affect the compensation deduction to which Corporation X is entitled because of the disqualification.

A must, of course, consider the impact on him of any taxes which might be imposed by the country in which he resides. But from the viewpoint of U.S. income taxes alone, the above example permits the fulfillment of an ojective often sought, namely the deduction by the employer, without taxable income to the employee.

The above principle should apply to the 510-day foreign residence rule set forth in Section 911(a)(2), although the more restrictive provisions of this rule must be considered. Also, an employee may have domestic service and foreign service, both of which have motivated the granting of the restricted stock option. In such an instance an equitable allocation to the period of foreign residence and service appears to be appropriate.

### DEPRECIATION ON BUSINESS PROPERTY SOLD DURING THE YEAR

A few years ago, in *Bertrand Cohn,* 259 F(2d) 371 (6th Circ., 1958), it was held that in computing depreciation on assets sold during the year, the selling price of the assets could be considered as representing the amount of the salvage value. In keeping with the requirement of Reg. Section 1.167 (a)-1(c) that an asset cannot be depreciated below salvage value, depreciation would be allowed for the year of the sale only to the extent that it did not reduce the depreciated basis

of the assets sold below their selling price.

The Internal Revenue Service has evidently been studying this decision in order to determine whether the principle should be limited to the year of sale or to all open years. In addition, there is the question of whether, in the event of a loss, depreciation can be adjusted upward. Pending the completion of this study, cases involving depreciation on assets sold during the year are apparently not being closed unless the taxpayer agrees to reduce the depreciation deduction on such assets by the amount of any gain which would result from their sale if depreciation were not reduced.

An interesting application of the *Cohn* rule has been experienced by a taxpayer reporting income from a construction contract on the completed contract method. The contract took three years to complete. For the first and second years no income or deductions were reported by the taxpayer. However, on its books depreciation was recorded monthly. In the third year, after the contract was completed, the taxpayer sold most of the assets at a gain.

The Internal Revenue Service at first sought to disallow the depreciation claimed over the life of the contract to the extent of the gain on the sale of the assets. The taxpayer was able to prevail at administrative levels with respect to the first and second years. The basis for the finding in his favor was the regular recording of depreciation on his books.

However, depreciation for the third year was limited in accordance with the rule of the *Cohn* case. The decision, although administrative, emphasizes the importance of maintaining regular records of depreciation.

REAL ESTATE DEALER AS A PARTNER

Many tax considerations are involved in determining whether a particular business should operate as a partnership or as a corporation. Often the most beneficial form for one participant may be detrimental to another. For example, A, an investor, and B, a dealer in real estate, are planning the construction and operation of an apartment house. They are reasonably certain that the project will result in substantial tax losses for the first few years and they would like to be able to offset such losses against their other income. Although they intend to hold the apartment house as a long-term investment, they fully realize that future circumstances may make a sale advisable. They do not wish to be prevented from selling by the prohibitive tax cost. B is also concerned about his ability to sustain the argument that a particular piece of real property owned personally by him could be considered investment property and thus eligible for capital gain treatment. Although recent cases have indicated that this position may be successfully maintained, it will be assumed, for the purpose of this illustration, that B's investment would not come within that scope.

If A and B form a partnership, each would achieve the objective of deducting his share of partnership losses in the initial years on his individual income tax returns. If after a few years they decide to sell at a substantial profit, B would be faced with a serious problem. If he sells his partnership interest, the portion of his proceeds attributable to the apartment house (presumably, the bulk of such proceeds) is considered to be derived from the sale of a non-capital asset under Sections 751(a) and 751(d)(2)(C).

As an alternative, if the apartment house is first distributed to the partners and then sold by them, his gain

would still be treated as ordinary income by reason of Section 735(a)(2).

If the partnership sells the apartment house directly, the results are not clear. Section 702(b) uses hazy language in discussing the determination of the "character" of items included in a partner's distributive share of partnership income, and the regulations only paraphrase the code. The Advisory Group on Subchapter K felt that Section 702(b) makes the determination of the character of the income at the partner level. If so, B could have ordinary income on the sale of the apartment house by the partnership even though the partnership held the apartment house for investment. To make certain that this interpretation is proper at least for the future, the Advisory Group has suggested a clarifying amendment to Section 702(b) (H. R. 9662). Even if this change is not enacted, in view of the difference of opinion as to the meaning of the section, as well as the strong possibility that the courts will take a stringent attitude in dealing with this type of situation, it is probably not safe to rely on Section 702(b) as a means of realizing capital gain for B, see, for example, J. Stewart Mathews, TC Memo. 1961—213.

It may be advisable for A and B to operate as a partnership for a few years and then to have B transfer his partnership interest to a new corporation organized by him. This approach may not be feasible if B's share of the liabilities are in excess of the basis of his partnership interest. Such excess would be ordinary income to B when he transfers his partnership interest to the new corporation by application of Sections 752(d) and 357(c).

Perhaps the solution would be a partnership between A and a nondealer corporation owned by B. In this way A may use his share of the partnership losses against his ordinary in-

come, and will not be prevented from realizing capital gain on any ultimate sale of the apartment house. Also, the corporation owned by B may reduce its other income by partnership losses and, if there is a sale, realize capital gain. From A's point of view, at least, this is preferable to forming a corporation to construct and operate the apartment house. In this latter case, A would be "locked in" for three years after the completion of the apartment house since B's status as a dealer could subject both shareholders to the collapsible corporation provisions of Section 341. THE END





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